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[JOINT COMMITTEE PRINT]

CURRENT TAX RULES RELATING TO FINANCIALLY TROUBLED SAVINGS AND LOAN ASSOCIATIONS

SCHEDULED FOR HEARINGS

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON FEBRUARY 22 AND MARCH 9, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled hearings on the budget implications and the current tax rules relating to financially troubled savings and loan associations. The hearings are scheduled on February 22 and March 9, 1989.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in connection with these hearings, discusses the budgetary considerations and reviews the current Federal income tax rules relating to thrift institutions, including savings and loan associations. Part I of the pamphlet is a background discussion of the thrift industry, including a description of the Federal deposit insurance system for thrift institutions—the Federal Savings and Loan Insurance Corporation (the "FSLIC") and the potential budgetary impact of the thrift industry financial problems. Part II provides a description of the present law tax rules applicable to thrift institutions. Part III provides a discussion of the issues raised by using the tax system to provide benefits to deposit insurers (such as the FSLIC) or to financially troubled thrift institutions.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Current Tax Rules Relating to Financially Troubled Savings and Loan Associations* (JCS–3–89), February 16, 1989.

I. BACKGROUND ON THE THRIFT INDUSTRY AND DEPOSIT INSURANCE

A. The Thrift Industry and Its Regulatory Structure

Overview

The thrift industry has experienced more economic distress over the last decade than during any other period since the Great Depression when the Federal Savings and Loan Insurance Corporation (the "FSLIC") and the Federal Deposit Insurance Corporation (the "FDIC") were established. In the period of stable interest rates from the 1930s to the 1970s, thrift institutions generally remained profitable. These institutions invested funds from low-rate, short-term deposits primarily in long-term, fixed-rate residential mortgages. High interest rates in the late 1970s and early 1980s, and then unexpectedly large loan losses in the mid-1980s through the present, have combined to severely weaken large numbers of thrift institutions as well as cause the FSLIC to become insolvent. By 1987, FSLIC-insured institutions reported an overall net annual loss of $6.6 billion and the reported deficit of the FSLIC reserve fund was $13.7 billion.[2]

The General Accounting Office (the "GAO") has estimated that resolution of the problems of financially troubled thrift institutions and restoration of the FSLIC reserve fund to acceptable levels will require $85 billion of expenditures in excess of the FSLIC's potential resources.[3]

Principal activities of the thrift industry

Savings and loan associations and mutual savings banks—collectively referred to as thrift institutions—are depository institutions which traditionally have specialized in residential mortgage lending.[4] Although mortgage assets continue to dominate the portfolios of the majority of thrift institutions, thrift institutions lending has changed dramatically in recent years. As shown in Table I-A, thrift institutions have significantly reduced their direct residential mortgage holdings over the last decade and have increased their indirect holdings of mortgages by investing in mortgage-backed securities. In addition, under expanded powers granted by the Depository Institutions Deregulation and Monetary Control Act of 1980, the Garn-St. Germain Depository Institutions Act of 1982, and new

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[2] Letter of Charles A. Bowsher, Comptroller General of the United States, to Danny Wall, Chairman of the Federal Home Loan Bank Board, May 17, 1988, reprinted in the *Federal Home Loan Bank Board 1987 Annual Report.*

[3] U.S. General Accounting Office Draft Report, *Troubled Financial Institutions: Solutions to the Thrift Industry Problem,* GAO/GGD–89–47, December 1988. (The final version of this report is expected to be released at the end of February 1989.)

[4] Sometimes the thrift industry also is defined to include credit unions. In this pamphlet, the term "thrift institutions" does not include credit unions.

State laws, thrift institutions have increased their consumer, commercial, and agricultural lending. Some thrift institutions have expanded their portfolios to include assets with greater default risk, such as acquisition, development, and construction loans ("ADC loans") as well as direct investment in real estate.

Table I-A.—Mortgage Holdings of Savings and Loan Associations and Mutual Savings Banks, 1974–1987

Year	As a percent of thrift institutions' total assets		As a percent of all U.S. residential mortgage holdings	
	Residential mortgages	Mortgage-backed securities	Residential mortgages	Mortgage-backed securities
1974	70.8	.....	53.0	.....
1975	68.1	.....	53.7	.....
1976	67.6	.....	54.6	.....
1977	68.6	.....	55.0	.....
1978	68.2	.....	53.6	.....
1979	69.4	2.7	51.2	2.0
1980	67.6	3.4	49.0	2.4
1981	66.1	3.9	47.0	2.8
1982	57.9	8.6	41.7	6.2
1983	56.2	11.3	40.0	8.0
1984	54.5	11.9	39.7	8.7
1985	50.0	10.5	37.8	7.9
1986	46.8	13.1	33.7	9.5
1987	46.4	15.5	32.1	10.7

Source: Board of Governors of the Federal Reserve System.

Regulation of the thrift industry and deposit insurance

Federal deposit insurance protects deposits on amounts up to $100,000 per deposit. Table I–B shows the number and total assets of both State and Federally chartered thrift institutions that are insured by the FSLIC and the FDIC. Although the number of both FSLIC- and FDIC-insured institutions has declined from over 4,500 in 1970 to less than 3,500 in 1988, assets of the thrift industry have grown steadily throughout this period.

Table 1-B.—Number and Assets of Federally-Insured Thrift Institutions, By Charter Issuer and by Insurance Provider, 1970–1988

Year	FSLIC-Insured		FDIC-Insured	
	State chartered	Federally chartered	State chartered	Federally chartered
A. Number of Institutions:				
1970	2,298	2,067	329	.....
1975	2,030	2,048	329	.....
1976	2,025	2,019	329	.....
1977	2,053	2,012	323	.....
1978	2,053	2,000	325	.....
1979	2,049	1,990	324	.....
1980	2,017	1,988	323	.....
1981	1,872	1,913	331	.....
1982	1,616	1,733	315	.....
1983	1,487	1,696	294	.....
1984	1,447	1,689	267	24
1985	1,525	1,721	364	28
1986	1,473	1,747	445	27
1987	1,379	1,768	462	22
1988[1]	1,274	1,724	470	21
B. Assets of Institutions (billions of dollars):				
1970	74	96	63	.....
1975	135	195	98	.....
1976	157	226	121	.....
1977	188	262	132	.....
1978	215	298	142	.....
1979	245	323	147	.....
1980	270	351	153	.....
1981	244	415	156	.....
1982	209	491	155	.....
1983	255	564	171	.....
1984	351	626	136	44
1985	386	685	157	48
1986	417	747	184	52
1987	436	814	217	45
1988 [1]	415	918	234	46

[1] 1988 FSLIC data as of November and 1988 FDIC data as of September.

Sources: Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation.

All Federally-chartered thrift institutions are regulated by the Federal Home Loan Bank Board (the "FHLBB"), and State-chartered thrift institutions that are insured by the FSLIC are regulat-

ed jointly by the FHLBB and the States which issued their charters. State-chartered thrift institutions that are insured by the FDIC are regulated jointly by the FDIC and the States which have issued their charters. Table I–C summarizes the thrift industry's deposit insurance and regulatory framework.

Table I–C.—Summary of Regulatory and Deposit Insurance Structure of the Thrift Industry

Charter	Number[1]	Assets (billions)[2]	Regulator
A. FSLIC-Insured Thrift Institutions (Saving and Loan Associations and Mutual Savings Banks):			
Federal/FHLBB	1,724	918	FHLBB.
State	1,274	415	FHLBB/State.
B. FDIC-Insured Thrift Institutions (Mutual Savings Banks):			
Federal/FHLBB	21	46	FHLBB.
State	470	234	FDIC/State.

[1] As of November, 1988.
[2] As of September, 1988.

Sources: General Accounting Office, Federal Home Loan Bank Board, and Federal Deposit Insurance Corporation.

The FSLIC was established by the National Housing Act of 1934 and has the responsibility of protecting deposits up to $100,000 in insured thrift institutions. The two major sources of income for the FSLIC's insurance fund are assessments from insured thrift institutions and investment income. Assessments are determined as a fixed fraction of total insured deposits. Since 1981, the FSLIC has suffered large losses from its insurance operations.[5] These insurance losses have caused the FSLIC's insurance fund reserves to decline from $6.5 billion at the end of 1980 (when they represented 1.35 percent of total FSLIC-insured deposits) to negative $13.7 billion at the end of 1987.[6]

The FSLIC is under the direction of the FHLBB. The FHLBB was established by the Federal Home Loan Bank Act of 1934. The FHLBB itself consists of a Chairman and two members who are appointed by the President and confirmed by the Senate to serve staggered four-year terms. The FHLBB and its staff provide administrative services for the FSLIC. In addition, the FHLBB approves charters for new Federal thrift institutions.

[5] See U.S. General Accounting Office, *Deposit Insurance: Analysis of Reform Proposals*, September 30, 1986, GAO/GGD-86-32A, pp. 50-59.
[6] See letter of Charles A. Bowsher, Comptroller General of the United States, to Danny Wall, Chairman of the Federal Home Loan Bank Board, May 17, 1988, reprinted in the *Federal Home Loan Bank Board 1987 Annual Report*.

The FHLBB and the FSLIC are on-budget agencies. The FHLBB oversees the operations of the twelve Federal Home Loan Banks, [7] the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Financing Corporation (the "FICO"),[8] which are off-budget entities, whose receipts and outlays are not included in the budget.

Financial condition of the thrift industry

A recurring threat to the profitability of the thrift industry has been rising interest rates. The Interest Rate Control Act of 1966 allowed the FHLBB to set rate ceilings on deposits offered by thrift institutions. While intending to provide a low-cost source of funds for thrift institutions, this legislation led to large outflows of deposits whenever market rates of interest exceeded ceiling rates, as in 1969 and in the mid-1970s. This phenomenon, known as disintermediation, occurs as depositors shift their savings from accounts with low, restricted interest rates to unregulated accounts, such as those of money market mutual funds.

In response to the threat of disintermediation, interest rate restrictions were gradually relaxed. In 1978, the FHLBB allowed thrift institutions to introduce six-month money market certificates with rates tied to the six-month Treasury bill rate. In 1980, in addition to loosening some restrictions on investments by thrift institutions, the Depository Institutions Deregulation and Monetary Control Act began a phaseout of interest rate restrictions over a six-year period. Although removal of restrictions on deposit rates alleviated the problem of disintermediation, the thrift industry's sensitivity to interest rates was not eliminated. Rather, high interest rates posed the problem of increasing the cost to thrift institutions of retaining deposits. In 1981 and 1982, rates on thrift institutions' predominantly short-term deposits closely paralleled the general rise in interest rates, while interest rates on the industry's portfolio of outstanding fixed-rate mortgages remained at low levels. This negative yield spread threatened the viability of the thrift industry.

In order to increase the rate of return on assets and to attempt to restore profitability, thrift institutions' investment powers were liberalized. At the Federal level, the Garn-St. Germain Depository Institutions Act of 1982 continued the liberalization of thrift institution investment restrictions that had begun in 1980. Thrift institutions were allowed to expand their lending to more commercial, consumer, and agricultural loans. In addition, some States, particularly Texas and California, further expanded the amounts and type of nonmortgage investments that could be made by thrift institutions chartered in their respective States.[9]

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[7] The twelve Federal Home Loan Banks are owned entirely by member institutions (primarily thrift institutions). The Federal Home Loan Banks make loans (called advances) to member institutions to boost liquidity and encourage mortgage lending.

[8] The Federal Savings and Loan Insurance Recapitalization Act of 1987 allowed the FHLBB to establish the FICO, a wholly-owned, off-budget entity. This agency may issue up to $10.825 billion in long-term bonds over the 1988-1990 period and no more than $3.75 billion in any one year. Interest on these bonds is paid by the FSLIC with funds from insurance premiums. The principal amounts of these bonds are secured by deep discount U.S. government bonds. These government bonds, which mature simultaneously with the FICO bonds, were purchased with proceeds from sale of the FICO stock to the Federal Home Loan Banks.

[9] See Federal Deposit Insurance Corporation, *Deposit Insurance in the Nineties-Meeting the Challenge-Draft Report*, January 1989, p. 314.

Despite the ameliorative effects of interest rate declines in 1982 and 1983, the health of the thrift industry was not restored. The decline in oil and agricultural prices caused a decline in the quality of loan portfolios heavily weighted with agriculture and oil industry loans. Losses were realized because of widespread defaults on loans.

Table I-D illustrates how the net worth of the thrift industry has declined in the 1980s. These figures underestimate the true decline in asset values due to increases in interest rates and declines in the value of collateral which have not been fully recognized.[10] If the assets of thrift institutions were valued at their fair market value, the net worth of thrift institutions would be even lower.[11]

Table I-D.—Net Worth of FSLIC-Insured Thrift Institutions, 1980–1988

Year	Number of thrifts	Total assets (billions)	As a percent of total assets		
			RAP net worth [1]	GAAP net worth [1]	Tangible net worth [1]
1980	4,002	615	5.24	5.24	5.23
1981	3,779	651	4.27	4.15	3.91
1982	3,343	686	3.69	2.95	0.54
1983	3,183	815	4.02	3.14	0.47
1984	3,136	977	3.80	2.78	0.33
1985	3,246	1,070	4.36	3.12	0.81
1986	3,220	1,164	4.49	3.34	1.27
1987	3,142	1,251	3.71	2.74	0.72
1988	3,092	1,290	3.23	2.32	0.36

[1] Net worth calculated according to regulatory accounting principles (RAP) is the sum of: preferred stock; permanent, reserve or guarantee stock; paid-in surplus; qualifying mutual capital certificates; qualifying subordinated debentures; appraised equity capital; net worth certificates; accrued net worth certificates; income capital certificates; reserves; retained earnings; and net undistributed income. Net worth calculated according to generally accepted accounting principles (GAAP) is equal to RAP net worth less the sum of: qualifying mutual capital certificates; qualifying subordinated debentures; appraised equity capital; net worth certificates; accrued net worth certificates; and deferred net losses. Tangible net worth is GAAP net worth less goodwill and other intangible assets. See U.S. General Accounting Office, *Thrift Industry—Forebearance for Troubled Institutions, 1982-1986,* May 1987, GAO/GGD-87-78BR.

Source: National Council of Savings Institutions

FSLIC case resolutions

The FSLIC is authorized to make loans to insured thrift institutions or facilitate the merger of an insured thrift institution if the

[10] See William Poole in Comments on "Thrift Industry Crisis: Causes and Solutions," *Brookings Paper on Economic Activity,* 1987, No. 2, pp. 381-384.

[11] Several authors have estimated that, with assets valued at fair market value, net worth of thrift institutions would have been about negative $100 billion in 1982. See Anthony Downs, *Revolution in Real Estate Finance,* Brookings Institution, Washington D.C., 1985, p. 213, and R. Dan Brumbaugh, Jr., *Thrifts Under Siege,* Ballinger Publishing Company, Cambridge, Massachusetts, 1988, Table 2.7.

insured institution is in default or its unstable condition increases the potential liability of the FSLIC. In a merger, the FSLIC may purchase assets or assume liabilities of the troubled thrift institution, make loans or contributions to the acquiring institution, or guarantee the acquiring institution against loss. However, the FSLIC may not provide assistance which exceeds the amount that the FSLIC determines to be the cost of liquidating the financially troubled thrift institution, unless the FSLIC determines the thrift institution provides essential financial services to the community.[12] Liquidations usually involve transferring the deposits of the liquidated institution to another insured institution. Less frequently, liquidations take the form of a depositor payout in which funds are paid by the FSLIC directly to the depositors.[13]

It is important to recognize the potentially large differences in the effects of liquidations and assisted mergers on the FSLIC's cash flow and on the Federal budget. When the FSLIC chooses to structure a case resolution by an assisted merger, amounts approximately equal to the excess of market value of the thrift insitution's liabilities over the market value of its assets are usually provided over a 10-year period. When the FSLIC chooses liquidation in the form of a depositor payout outlays equal to the total amount of liabilities are provided in the first year, while recoveries of the market value of the assets are received over a period often greater than five years. As has been noted by the GAO, " [the] FSLIC's strategy for maximizing its limited financial ability to act on seriously troubled institutions . . . emphasizes using acquisitions or mergers rather than liquidations. . . ." [14]

The FSLIC has resolved 721 cases since its creation in 1934 until the end of 1988, including 205 in 1988. As shown in Table I–E, there was a large increase in the number of case resolutions at the end of 1988 over and above the record pace of case resolutions in 1988. Many cases were resolved under the program instituted by the FHLBB, known as the "Southwest Plan," which concentrated FHLBB efforts on FSLIC-assisted mergers and consolidation of the large number of problem thrift institutions in Texas.

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[12] 12 U.S.C. sec. 1729(f).

[13] *Federal Home Loan Bank Board 1987 Annual Report*, Washington, D.C., 1988, p. 13.

[14] Frederick D. Wolf, "The Federal Savings and Loan Insurance Corporation's Use of Notes and Assistance Guarantees," U.S. General Accounting Office Testimony before the Committee on Banking, Finance, and Urban Affairs, September 8, 1988, p. 10.

Table I-E.—FSLIC Case Resolutions, 1980–1988

Year	Liquidations	FSLIC-assisted mergers		Total resolutions
		Non-Southwest plan	Southwest plan	
1980	0	11	0	11
1981	1	27	0	28
1982	1	62	0	63
1983	6	31	0	37
1984	9	13	0	22
1985	11	20	0	31
1986	21	26	0	47
1987	17	30	0	47
1988	26	99	80	205
1988:				
January	3	1	0	4
February	2	3	0	5
March	3	5	0	8
April	2	3	0	5
May	1	2	9	12
June	3	4	2	9
July	4	4	0	8
August	0	14	13	27
September	2	15	11	28
October	2	2	11	15
November	4	4	1	9
December	0	42	33	75

Source: Federal Home Loan Bank Board.

B. Potential Budgetary Impact of the Problems in the Thrift Industry

1. Measuring the cost of the problem

In order to understand the potential budget impact of the FSLIC's insurance obligation on the Federal budget, it is useful to distinguish between two measures. First, there is the overall amount of assistance that the FSLIC must provide to cover the excess of the market value of insured deposits of insolvent thrift institutions over the market value of the assets of insolvent thrift institutions. This may be referred to as "the total cost of resolution." Second, there is the excess of total cost of resolution over the FSLIC's own resources. This amount, which may be referred to as "the FSLIC's shortfall," determines the amount of additional funds that must be provided from other sources.

The total cost of resolution

It is widely reported that estimates of the total cost of resolution range from $50 billion to $100 billion.[15] These costs can be compared to total deposits in FSLIC-insured institutions at the end of September 1988 of $974 billion, of which $893 billion (92 percent) were insured by the FSLIC.[16]

The total cost of resolution is difficult to estimate for several reasons. First, the number of institutions that ultimately must be assisted is uncertain. Second, the market value of the assets of financially troubled FSLIC-insured institutions is uncertain. Third, regardless of the current fair market values of the assets, such values are likely to change as real estate and financial market conditions change. This adds uncertainty to cost estimates since immediate resolution of all cases is unlikely. Finally, the ultimate cost to the FSLIC depends on the method and timing of case resolutions. It is widely agreed that allowing insolvent thrifts to remain open without strict supervision will increase the cost of resolution.[17] Commentators also note that a recession or a rise in interest rates could substantially increase costs.[18]

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[15] Such estimates are reported (but not actually estimated) by the *Economic Report of the President*, Washington D.C., U.S. Government Printing Office, January 1989, p. 200; the Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1990-1994*, January 1989, p. 67; and the Federal Deposit Insurance Corporation, *Deposit Insurance in the Nineties—Meeting the Challange—Draft Report*, January, 1989, p. 325. The FDIC states that the cost of resolution ranges from $45 billion to $100 billion, but also notes that an additional $15 billion will be required in order to recapitalize adequately the FSLIC.

[16] Figures on total and insured deposits have been provided by the Federal Home Loan Bank Board.

[17] See Council of Economic Advisors, *Economic Report of the President*, Washington D.C., U.S. Government Printing Office, January 1989, p. 200; and General Accounting Office Draft Report, *Troubled Financial Institutions: Solutions to the Thrift Industry Problem*, December 1988, GAO/GGD-89-47, pp. 62-70.

[18] The Federal Home Loan Bank Board itself has noted that a reduction of 25 basis points in the cost of funds would reduce losses for the entire thrift industry by $2.3 billion. See the *Federal Home Loan Bank Board 1987 Annual Report*, p. 12.

The FSLIC's shortfall

A framework for calculating the FSLIC's shortfall is presented in Table I–F. For purposes of illustration, Table I–F also provides GAO estimates which roughly correspond to the concepts outlined in the Table. (Since the GAO estimates are used only for purposes of the illustration, the staff has not attempted to verify GAO estimates.) Given an estimate of the total cost of resolution, the next step in estimating the FSLIC's shortfall is estimation of its net funds available for future case resolutions. This amount is total resources less the sum of expenses and funds already committed to old cases not included in projections of future case resolutions. The calculation of net funds available for future case resolutions is shown in Part A of Table I–F.

Table I-F.—Framework for Calculating the FSLIC's Shortfall

	GAO estimate for 1988–1998 ($ billions)
A. Calculation of Net Funds Available for Future Case Resolutions:	
(A1) FSLIC's gross sources of funds	approximately 54
(A2) −Expenses	approximately 4
(A3) −Funds for previous cases	approximately 23
(A4) = Net funds available to FSLIC for future cases.	approximately $27.
B. Calculation of the FSLIC's Shortfall:	
(B1) Total cost of resolution	approximately 92
(B2) + Establishment of reserve fund	approximately 20
(B3) − Net funds available to FSLIC for future cases.	approximately 27
(B4) = The FSLIC's shortfall	approximately 85

The figures in parentheses are from Tables 2.3, 2.4, and 2.5 of the General Accounting Office Draft Report, *Troubled Financial Institutions: Solutions to the Thrift Industry Problem*, December 1988, GAO/GGD–89–47. The figures are not present values but projected 11-year totals of expenditures from 1988 to 1998. Included in the figure for total cost of resolution are the GAO's estimate of $10 billion of financing costs and $5 billion for resolution of cases not yet identified.

Using the calculations from Part A of Table I-F, Part B of that Table shows the relationship of the total cost of resolution to the FSLIC's shortfall. The amount of the FSLIC shortfall must be provided from other sources if the FSLIC meets its obligations to depositors and reestablishes its insurance fund reserve.

Under the GAO's method of estimating total sources of funds, it is assumed that the FSLIC will have no extraordinary sources of income. The FSLIC's sources of funds include its regular insurance assessment equal to one-twelfth of one percent of all insured deposits, a special assessment (since 1985) on insured institutions equal to an additional one-eighth of one percent of all insured deposits, sales of FICO bonds, sale of assets acquired from liquidated thrift institutions, and interest on investments.[19] The GAO's estimates are not expressed in terms of present values. Estimates from other sources can also be utilized in this framework. Given such estimates, the adequacy of any additional funding can be measured by comparing the present discounted value of funds made available to

[19] In addition, the FSLIC has: authority to borrow from the Federal Home Loan Banks; a line of credit from the Treasury for up to $750 million; and authority to borrow an amount up to one percent of insured deposits from insured institutions. These potential sources of funds are not included in the GAO's estimate of the FSLIC's total sources of funds.

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the FSLIC (whether direct outlays or bond proceeds) to the present discounted value of the FSLIC's shortfall.

As has been noted elsewhere, the FSLIC deposit insurance liability is a contingent claim that exists regardless of whether this claim remains implicit (i.e., the claim that depositors have against the FSLIC should a FSLIC-insured institution be unable to meet its deposit liabilities) or is explicitly acknowledged by contractual agreements between the FSLIC and acquirers of insolvent thrift institutions.[20] As a result, a large number of case resolutions, such as those which occurred in December 1988, do not greatly change the estimate of the FSLIC's shortfall. As cases are resolved, the projected total cost of future resolution (line B1 in Table I-F) is reduced, and funds already committed to existing cases (line A3) are increased; therefore, the net funds available to the FSLIC for future cases (line B3) are correspondingly reduced.

[20] G. Thomas Woodward, "FSLIC, the Budget, and the Economy," Congressional Research Service, No. 89-17E, January 12, 1989.

2. Budget projections for FSLIC outlays

Reagan Administration budget

The Reagan Administration's proposed budget for fiscal year 1990 estimates that projected outlays by the FSLIC will equal approximately $31 billion for the 1989–1994 fiscal year period. These figures are presented in Table I-G. The Reagan Budget states that these figures do not represent additional sources of funds which would be available from a comprehensive reform plan. However, according to the Reagan Budget, these outlays would be sufficient for "the FSLIC to close at least 100 of the most unprofitable of the remaining GAAP insolvent institutions, which accounted for over 77 percent of the 3rd quarter losses realized by all involvent thrifts." [21]

Table I-G.—Reagan Administration Budget Projection for the FSLIC

[in billions of dollars]

Fiscal year	1989	1990	1991	1992	1993	1994	Total
Disbursements	15.9	9.1	10.2	8.6	10.0	10.2	64.0
Receipts	−7.2	−7.0	−3.6	−3.7	−5.1	−6.8	−33.4
Net outlays	8.7	2.1	6.6	4.9	4.9	3.4	30.6

Source: *Budget of the United States Government, Fiscal Year 1990,* p. 2-34.

CBO January 1989 budget baseline

In the CBO budget baseline, outlays by the FSLIC equal approximately $54 billion for the 1989–1994 fiscal year period. These figures are presented in Table I-H. According to the CBO, on a present value basis, these estimates allow for roughly between $45 billion and $50 billion of on-budget spending to meet the FSLIC's shortfall.

[21] *Budget of the United States Government, Fiscal Year 1990,* p. 2-34.

Table I-H.—Congressional Budget Office January 1989 Baseline Budget Projection for the FSLIC

[In billions of dollars]

Fiscal year	1989	1990	1991	1992	1993	1994	Total
Disbursements	20.5	17.2	15.0	10.1	9.7	8.8	81.3
Receipts	−7.5	−6.8	−3.4	−3.3	−3.2	−3.3	−27.5
Net outlays	13.0	10.4	11.6	6.8	6.5	5.5	53.8

Source: Congressional Budget Office.

Bush Administration plan for resolution of the FSLIC's caseload

On February 6, 1989, the Bush Administration announced a new reform plan to resolve the problems of the thrift industry.[22] The Bush Administration also announced that the FDIC and the FSLIC will immediately begin joint supervision of insolvent thrift institutions. The reform plan includes several structural changes in the deposit insurance system: the separation of the FSLIC from the FHLBB; the renaming of the FHLBB to the Federal Home Loan Bank System; the replacement of the current three-member FHLBB with a single chairman; and an increase in the capital requirements of thrift institutions to levels equal to the capital requirements of FDIC-insured banks by June 1, 1991. The Bush Administration plan includes the creation of a Resolution Trust Corporation (the "RTC") to complete the resolution of insolvent thrift institutions. The RTC will be staffed by the FDIC, and will have an Oversight Board comprised of the Secretary of Treasury, the Chairman of the Federal Reserve Board, and the Comptroller General of the United States.

The Bush Administration plan includes several new sources of funding. The plan establishes an off-budget agency called the Resolution Funding Corporation (the "REFCO"), which will issue $10 billion of 30-year bonds in fiscal year 1989, $25 billion in fiscal year 1990, and $15 billion in fiscal year 1991. The principal of these bonds will be collateralized with zero-coupon Treasury bonds purchased with the retained earnings of the Federal Home Loan Banks and special assessment premiums from insured institutions. According to the Office of Management and Budget, interest payments will be paid through a combination of industry and Treasury funds.

The plan also would increase insurance premiums on FSLIC-insured institutions. The current combined regular and special insurance assessment of .208 percent of insured deposits would continue through 1990, increase to .230 percent in 1991 through 1993, and decline to .180 percent in 1994 and thereafter. (Although the plan does not include any commingling of the FDIC and the FSLIC insurance funds, FDIC-insured institutions would increase their insurance premiums from the current level of .083 percent to .120 percent in 1990 and to .150 percent in 1991 and future years.)

The Office of Management and Budget's estimates of the budgetary impact of this plan are shown in Table I–I. Although the

[22] The details of this plan, described below in this subsection, are enumerated in: a statement by Nicholas F. Brady, The Secretary of the Treasury, "Regarding the President's Savings and Loan Reform Program," Department of the Treasury, February 6, 1989; a White House Press release, "Fact Sheet: The President's Reform Plan for the Savings and Loan Industry," February 6, 1989; and a Supplement to President Bush's February 9, 1989. Message delivered to a Joint Session of Congress, *Building a Better America*, February 9, 1989, pp. 143–146.

FSLIC's net outlays are comparable to those under the Reagan Administration's budget proposal, more resources would be available for case resolution primarily because of $50 billion of off-budget REFCO financing.

Table I-I.—Summary of Budgetary Effects of the February 6, 1989 Bush Administration Plan for Resolution of the FSLIC Caseload

[in billions of dollars]

Fiscal Year	1989	1990	1991	1992	1993	Total
Disbursements	27.7	31.2	22.5	7.8	8.3	97.4
Receipts	−17.0	−29.8	−16.5	−3.2	−3.6	−70.0
Net outlays	10.7	1.4	6.0	4.6	4.7	27.4
Addendum:						
Treasury payments of REFCO bond interest	.5	1.4	1.6	.9	.8	5.2
Additional FDIC insurance premiums	.0	−.8	−1.6	−1.7	−1.8	−6.0

Source: Supplement to the President's Message to the Joint Session of Congress, *Building A Better America,* February 9, 1989, p. 145.

3. Other budget issues

On-budget versus off-budget financing alternatives

Two alternative methods of financing FSLIC's shortfall are disbursements from the Treasury and the issuance of bonds by an off-budget government agency. Primarily because of lower financing costs, direct expenditures are likely to be less costly. However, direct expenditures to fund completely current estimates of the FSLIC's shortfall over any short period of time, without any major new revenue increases or further spending reductions, would substantially increase projections of Federal budget deficits. Budget projections that exceed Gramm-Rudman-Hollings deficit targets could trigger sequestration.

Financing through an off-budget agency (for example, through a new special-purpose government agency, as has been proposed by the Bush Administration, or through the FSLIC if it were taken off-budget) may provide a means of avoiding a possible Gramm-Rudman-Hollings sequestration. An off-budget agency could issue bonds whose proceeds could be used by the FSLIC to resolve its problem cases. If notes are issued by an off-budget agency, increased outlays by the Federal government would be realized only as interest and principal payments on the bonds were made by the Treasury. Under this type of mechanism, funds could be made immediately available to the FSLIC while the budgetary impact could

be spread over a period extending to the maturity date of the bonds. However, the costs of this type of financing would be greater than direct Treasury funding since it is unlikely that a financing entity could be off-budget and, at the same time, issue bonds with interest and principal backed by the full faith and credit of the Federal government.

Interaction of tax revenues and direct outlays

The amount of direct expenditures needed by the FSLIC and by the Federal government to meet the FSLIC's insurance obligation to depositors of financially troubled thrift institutions depends upon tax treatment of FSLIC-assisted mergers. To some extent, the required assistance for each case resolution can be reduced by any tax benefits available to troubled thrift institutions. Although tax incentives may decrease expenditures by the FSLIC for case resolutions, the overall impact on the budget—taking into account expenditures and tax revenues—is greater with the provision of tax incentives unless the FSLIC expenditure reductions completely offset reductions in tax revenues.

In addition to affecting the amount of outlays, tax incentives can greatly alter the timing of outlays and the structure of resolutions by the FSLIC. This occurs because tax rules provide greater benefits for FSLIC-assisted mergers than liquidations. As a result, the after-tax cost to the FSLIC of mergers is lowered relative to the cost of liquidation. As discussed in Part I.A of this pamphlet, *supra*, liquidations typically require greater up-front cash outlays than do assisted mergers.[23] (See Part III of this pamphlet, *infra*, for discussions of issues in providing assistance through the tax system.)

[23] The revenue estimates of extension of the special tax rules for financially troubled thrift institutions in the Technical and Miscellaneous Revenue Act of 1988 took into account any potential outlay saving to the FSLIC resulting from the availability of tax benefits for FSLIC-assisted mergers.

II. SPECIAL TAX RULES RELATING TO SAVINGS AND LOAN AND OTHER THRIFT INSTITUTIONS

A. Tax Rules Applicable to All Thrift Institutions

1. Reserves for bad debts and deductions for worthless debts

General tax rules

Under present law, taxpayers are permitted a deduction equal to the adjusted basis of any debt which is acquired or incurred in the taxpayer's trade or business which becomes wholly or partially worthless during the taxable year (Code sec. 166). In general, taxpayers may deduct specific bad debts only in the year in which they become worthless or partially worthless (the "specific charge-off method"). After 1986, "small banks"[24] are permitted to use the more generous "reserve method." Under the reserve method, a taxpayer is permitted a deduction for an addition to a reserve for bad debts. When debts are determined to be wholly or partially worthless, no deduction is allowed, but the amount of the bad debt is charged against the reserve (i.e., the reserve is reduced).

Under the reserve method used by small banks, also called the "experience method," the addition to the reserve for bad debts is generally an amount necessary to increase the loan loss reserve at the close of the taxable year to a percentage of total loans outstanding at the close of that year equal to the ratio of total bad debts in the current and 5 preceding taxable years to the sum of loans outstanding at the close of those years.[25] In addition, the annual addition may be increased by the amount necessary to increase the balance of the loan loss reserve to the balance of the reserve at the close of the base year (or, if the total amount of loans outstanding at the close of the taxable year is less than the loans outstanding at the close of the base year, a proportionate part of the loans outstanding at the close of the taxable year). Currently, the base year is the last taxable year beginning before 1988.

The time at which a debt becomes wholly or partially worthless depends on all the facts and circumstances of the particular case. In general, bad debts are recognized, or are charged off against a reserve, only when some identifiable event has occurred which establishes their worthlessness. In the case of banks, thrift institutions, and other regulated companies, Treasury regulations provide a conclusive presumption of worthlessness if such worthlessness is certified by the supervisory authorities for the institution.[26] As a

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[24] A small bank means a bank in which the adjusted bases of its assets (or the assets of any controlled group of which such bank is a member) do not exceed $500 million (sec. 585(c)).

[25] Taxpayers may use an averaging period shorter than 6 years with the approval of the Secretary of the Treasury. Such approval may be given in cases where the taxpayer can demonstrate that there has been a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased. Treas. regs. sec. 1.585–2(c)(1)(ii)).

[26] Treas. regs. sec. 1.166-2(d)(1).

result, such institutions have some flexibility in determining the timing of their bad debt deductions (if using the specific charge-off method) or the charge against the reserve (if using the reserve method).

Thrift institutions

Under present law, certain savings and loan associations,[27] mutual savings banks, and cooperative banks without capital stock which are organized and operated for mutual purposes and without profit (collectively called "thrift institutions" in Part II. of this pamphlet) generally are granted more favorable tax treatment in the computation of their bad debt deductions than banks or other taxpayers if their assets meet certain requirements. Thrift institutions whose assets do not meet these requirements are subject to the same tax treatment in the computation of their bad debt deductions as banks.

Thrift institutions holding 60-percent qualifying assets

If a thrift institution holds 60 percent of its assets as so-called "qualifying assets" (generally cash, government obligations, and loans secured by residential real property), the institution is eligible to compute the deductible additions to its bad debt reserve under either the specific charge-off method or the reserve method. If such a thrift institution uses the reserve method of accounting for bad debts, it may elect each year to calculate its annual addition to its bad debt reserve under modified versions of either the experience method used by small banks or the "percentage of taxable income" method (sec. 593(b)). In determining the amount of an allowable loan loss deduction, special rules apply with respect to "qualifying real property loans" and "nonqualifying loans." In general, a qualifying real property loan is any loan secured by an interest in real property that is to be improved out of the proceeds of the loan. A nonqualifying loan is any loan which is not a qualifying real property loan.

Under the percentage of taxable income method, a thrift institution is allowed a deduction for additions to its loan loss reserve equal to 8 percent of its taxable income (subject to certain adjustments) for the taxable year. Limitations are, however, placed on this addition. First, the amount determined under the percentage of taxable income method must be reduced (but not below zero) by the amount of the loan loss addition for that taxable year determined under the experience method with respect to nonqualifying loans.[28] Second, the addition to the reserve for qualifying real property loans may not exceed the amount necessary to increase the balance of such reserve at the close of the taxable year to 6 percent of such loans outstanding at the close of the taxable year. Third, the overall bad debt reserve addition cannot (including the experience method allowance related to nonqualifying loans)

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[27] For purposes of this pamphlet, the term "savings and loan association" includes a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association.

[28] A thrift institution using the percentage of taxable income method is entitled to a deductible addition to a reserve for losses on nonqualifying loans calculated under the experience method in addition to the amount based on taxable income.

exceed the greater of (1) the amount determined under the experience method, or (2) the excess of 12 percent of total deposits or withdrawable accounts of depositors at the close of the taxable year over the sum of surplus, undivided profits, and reserves at the beginning of the taxable year.

The percentage of taxable income method subjects thrift institutions to tax on only part (92 percent) of their income. Accordingly, on the principle that deductions should not be allowed against exempt income, present law imposes limitations upon some of the otherwise allowable deductions and credits of thrift institutions. Thrift institutions are entitled to only one-half of the targeted jobs tax credit available to taxpayers generally. In addition, although corporations generally are entitled to a deduction of 70 percent (80 percent or 100 percent in certain circumstances) of all dividends received from domestic corporations, thrift institutions using the percentage of taxable income method must reduce by 8 percent the amount of the dividends received deduction (sec. 596).[29]

Thrift institutions not holding 60-percent qualifying assets

If a thrift institution does not hold 60 percent of its assets as qualifying assets, the entity generally is treated as a commercial bank if it otherwise satisfies the definition of a bank in section 581. If the adjusted bases of the assets of such an entity (or any controlled group of which the entity is a member) exceed $500 million, the entity is considered a large bank and is ineligible to use the reserve method of computing deductions for losses on bad debts (i.e., it must use the specific charge-off method). If the adjusted bases of the assets of the entity do not exceed $500 million, the entity may be considered a small bank and may be eligible to use either the specific charge-off method or the experience method.

2. Limitations on net operating loss carryovers

General tax rules

Under present law, taxpayers generally may carry net operating losses back to the prior three taxable years and forward to the succeeding 15 taxable years (sec. 172(b)(1)).

Thrift institutions

Section 903 of The Tax Reform Act of 1986 (the "1986 Act") provided that thrift institutions are subject to the same carryover and carryback periods generally applicable to other taxpayers, with the following exceptions. First, net operating losses incurred by a thrift institution in taxable years beginning after December 31, 1981, and before January 1, 1986, may be carried back to the prior 10 taxable years and carried forward to the succeeding eight taxable years. Second, if a thrift institution is treated as a large bank, the portion of net operating losses for any taxable year beginning after December 31, 1986, and before January 1, 1994, that is attributable to deductions for bad debts is carried back to the prior 10 taxable years

[29] In addition, the amount by which the deduction for an addition to a bad debt reserve exceeds the amount that would have been allowable as a deduction under the experience method is a preference item under the alternative minimum tax. *See* the discussion of the alternative minimum tax in Part II.B.6. of this pamphlet, *infra*.

and carried forward to the succeeding five taxable years. The portion of the net operating loss attributable to deductions for bad debts is the excess of the net operating loss for the taxable year over the net operating loss for such taxable year computed without regard to any deductions for bad debts.

Tax-free acquisitions of financially troubled thrift institutions are also subject to special favorable rules concerning the carryover of net operating losses. (These rules are discussed in Part II.B.3.a. of this pamphlet, *infra*.)

3. Deductibility of dividends by thrift institutions

In determining their taxable income, thrift institutions are allowed a special deduction from gross income for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts (sec. 591). Because these amounts are in the nature of interest, this deduction is allowed regardless of whether the amounts are denominated as dividends or interest. In order to be deductible, however, such amounts must be withdrawable on demand, subject only to the customary notice of intention to withdraw. Thus, amounts paid as a dividend on the non-withdrawable capital stock accounts of a savings and loan association or a mutual savings bank are not deductible. Such a nondeductible dividend is treated as a distribution with respect to stock as it is in the case of any other corporation.

The deduction for amounts credited as dividends or interest by thrift institutions is allowed in the taxable year in which such amounts become withdrawable by the depositor or account holder.

4. Foreclosure of property securing loans

In general, foreclosure by a creditor on property in which the creditor holds a security interest is a taxable event to the creditor. First, the creditor may realize a deductible bad debt loss on the foreclosure if part or all of the debt foreclosed upon is worthless. Second, if the creditor acquires the property at the foreclosure sale, the creditor is treated as disposing of the debt in exchange for the fair market value of the property foreclosed upon. Thus, the creditor may recognize gain or loss on the foreclosure if the property received has a fair market value more or less than his basis in the amount of the underlying debt. The creditor takes a basis in the acquired property equal to its fair market value. Later, if the property is disposed of in a taxable event, additional gain or loss may be recognized.

Since the Revenue Act of 1962, special treatment has been provided for thrift institutions which acquire by foreclosure any property which is security for payment of a debt. If a thrift institution forecloses on the security for a debt owed to the institution (or otherwise reduces the property to ownership or possession by any process of law or by agreement), no gain or loss is recognized and no debt is considered as having become wholly or partially worthless regardless of the property's fair market value at the time of the foreclosure. Thus, the loan transaction is held open and the property received in the foreclosure (or other proceeding) is treated for tax purposes as having the same characteristics as the debt for

which it was security.[30] The thrift institution's basis in the acquired property is equal to its adjusted basis in the debt, increased by the costs of acquisition.

While, under this provision, the acquisition of the security by foreclosure (or other legal means) is not itself a taxable event to a thrift institution, foreclosure may still have tax effects in the taxable year of foreclosure or later taxable years. For example, if the property foreclosed upon has declined in value below the thrift institution's basis in the property (generally, the amount of the debt outstanding at the time of the foreclosure, adjusted for acquisition costs), the decline may be charged against the bad debt reserve of the institution (if that is proper under the institution's method of accounting), and the basis of the property is reduced accordingly. If the property continues to decline in value, further bad debt deductions may be taken. When the property is later disposed of, the amount realized is treated as a payment on the debt thereby closing the loan transaction.

B. Tax Rules of Special Significance to Financially Troubled Thrift Institutions

Congress enacted several tax provisions in the Economic Recovery Tax Act of 1981 (the "1981 Act") intended to aid the thrift industry.[31] These provisions provide relief to financially troubled thrift institutions or the acquirers of such institutions by: (1) excluding certain payments made to financially troubled thrift institutions by the Federal Savings and Loan Insurance Corporation (the "FSLIC") from the income of such thrift institutions; (2) providing that most reorganizations of financially troubled thrift institutions are tax-free; (3) relaxing loss carryover rules; and (4) not applying a recapture rule to financially troubled thrift institutions making certain distributions to the FSLIC. The 1985 House tax reform bill, H.R. 3838, would have repealed all but the last of these provisions as of July 1, 1986. The Senate version of the tax reform bill did not repeal these special rules. The conferees agreed, in section 904 of the 1986 Act, to repeal all but the last of these provisions, effective generally after December 31, 1988. However, section 4012 of the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") extended for one year the effective date of the repeal of these provisions and made certain modifications to the provisions, including the extension of these provisions to banks and the Federal Deposit Insurance Corporation (the "FDIC").

As will be described below, the provision excluding certain payments made by the FSLIC to financially troubled thrift institutions from the income of such thrift institutions provides benefits whether the financially troubled thrift institution is liquidated by the FSLIC or is merged with another entity. The tax benefits arising from the provisions providing that most reorganizations of financially troubled thrift institutions are tax-free and relaxing loss carryover rules apply only if the troubled thrift institution is merged with another entity.

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[30] Thus, no depreciation deductions are allowable with respect to the acquired property.
[31] Sections 241-244 and 246 of the 1981 Act, effective for taxable years after 1980.

1. FSLIC contributions

General tax rules

Prior to the 1981 Act, the tax treatment of a payment from the FSLIC to a thrift institution was unclear. A payment could be treated as gross income to the recipient thrift institution. Alternatively, taxpayers might take the position that the payment was a contribution to the capital of the thrift institution, in which case it would not be includible in gross income (sec. 118). If the payment was characterized as a contribution to capital, the tax consequences would vary depending upon whether the payment was treated as a non-shareholder or shareholder contribution to capital. If characterized as a non-shareholder contribution to capital, the basis of property held by the recipient thrift institution normally would be reduced by the amount of such contribution (sec. 362(c)). If characterized as a shareholder contribution to capital, there would be no basis adjustment.[32]

Income exclusion

The 1981 Act provided that amounts transferred by the FSLIC to certain financially troubled thrift institutions under its financial assistance program were not includible in the gross income of the recipient thrift institutions and such thrift institutions do not reduce their basis in property by the amount of such contributions (sec. 597). This income exclusion is scheduled to expire, in general, for assistance payments made by the FSLIC after December 31, 1989, unless pursuant to acquisitions on or before that date. After such expiration, the general tax rules described above would apply to the receipt of FSLIC assistance payments.

In addition, in 1986 and 1988, Congress provided that the general rule disallowing deductions for expenses and interest relating to tax-exempt income (sec. 265) would not apply to deductions allocable to amounts excluded from gross income pursuant to section 597.[33]

Tax attribute reduction

In 1988, Congress reduced the tax benefit associated with the complete exclusion of FSLIC assistance from the gross income of the recipient thrift institution. The 1988 Act provided, in general, for a reduction in certain tax attributes of a financially troubled thrift institution equal to 50 percent of the amount of assistance provided by the FSLIC and excluded from the gross income of the thrift institution for any taxable year under section 597 (the "50-percent cutback").[34] The 50-percent cutback is to apply to the tax

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[32] The current administrative approach taken by the Internal Revenue Service (the "IRS") for private ruling purposes is that, absent legislation to the contrary, a payment from the FSLIC to a financially troubled thrift institution is not a contribution to capital and, therefore, is taxable as ordinary income to the recipient thrift institution upon receipt. *See* LTR 8835057 (June 10, 1988). The IRS has not always taken this position on the issue for private ruling purposes (*see* LTR 8243025 (July 22, 1982)) and it is possible that their current position could change.

[33] Section 904(c)(2)(B) of the 1986 Act and section 4012(c)(2) of the 1988 Act.

[34] The 50-percent cutback applies, in general, to assistance payments made (1) after December 31, 1988, and before January 1, 1990, unless pursuant to an acquisition occurring before January 1, 1989, and (2) after December 31, 1989, if pursuant to an acquisition occurring after December 31, 1988, and before January 1, 1990.

attributes of the thrift institution in the following order: (1) any "pre-assistance net operating loss" for the taxable year; (2) the amount of any interest deduction for the taxable year; and (3) any "recognized built-in portfolio losses" for the taxable year.

A pre-assistance net operating loss is, in general, any net operating loss of the financially troubled thrift institution which accrues before the FSLIC determines that the financial condition of the thrift institution requires financial assistance (the "determination date").[35] A recognized built-in portfolio loss is any loss recognized on the disposition of a thrift institution's loan portfolio, marketable securities, and property securing loans acquired through foreclosure, except to the extent that the thrift institution establishes that any such asset was not held by the thrift institution immediately before the determination date or such loss exceeds the excess of the adjusted basis of such asset on the determination date over the fair market value of such asset on such date.

Application of section 597 to particular types of FSLIC assistance in tax-free acquisitions

Although the special rules of section 597 as originally enacted, and as modified and extended in the 1988 Act, resolved certain ambiguities in the tax treatment of FSLIC assistance, some of the more technical tax consequences associated with the receipt of such agency assistance are still uncertain. The discussion below reflects the apparent administrative practice of the IRS on some of these issues, as that practice is revealed in recently issued private letter rulings. Private letter rulings are binding on the IRS only with respect to the taxpayer who requested the ruling. These letters may not be used or cited as precedent, and may not in all cases accurately reflect the current IRS position on a particular issue.

The FSLIC may make several different types of financial assistance payments to a financially troubled thrift institution in connection with a reorganization. It is the present administrative approach taken by the IRS for private ruling purposes that different types of assistance payments are treated differently for tax purposes. Some payments are treated as made to the troubled thrift institution before the acquisition and some payments are treated as made to the reorganized thrift institution after the acquisition. The FSLIC commonly provides one or more of the following types of financial assistance, among others, in connection with the acquisition of a financially troubled thrift institution: (1) negotiated cash payments; (2) negative net worth notes and interest thereon; (3) capital loss guarantees; (4) yield maintenance payments; and (5) guarantees or reimbursements of the cost of certain expenses related to the acquired assets.[36]

A negotiated cash payment is a lump sum cash payment negotiated between the FSLIC and the acquirer of a financially troubled thrift institution. A negative net worth note generally is an interest-bearing term note with a face amount equal to the difference of

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[35] The reduction in net operating loss carryovers is to be made in the order in which carryovers are taken into account for the taxable year.

[36] In contrast, the assistance provided by the FDIC to financially troubled financial institutions has been in the form of negotiated cash payments.

the time of the acquisition, between the book value of the assets of the financially troubled thrift institution and its liabilities. The note brings the net worth of the troubled thrift institution up to zero. A capital loss guarantee generally is a guarantee by the FSLIC of all or a portion of the stated book value of certain assets acquired from a financially troubled thrift institution. Under such a guarantee, if the guaranteed assets are disposed of for a price less than the guaranteed value, the FSLIC will reimburse the thrift institution for the difference. A yield maintenance payment generally is an amount paid by the FSLIC with respect to certain assets acquired from a financially troubled thrift institution which is intended to supplement the yield on such assets. The amount of such payments may be calculated as the difference between a predetermined rate that is applied to the book value of certain (usually non-earning) assets and the actual yield (if any) on such assets, or may be calculated so as to eliminate or reverse the difference between the low interest income yielded on the assets acquired from the financially troubled thrift institution and the institution's higher cost of funds. Guarantees or reimbursements of the cost of certain expenses related to the acquired assets of a financially troubled thrift institution may be made by the FSLIC, either directly or indirectly through the setting of the yield maintenance rate or other aspects of other guarantees.

Negotiated cash payments and negative net worth notes

The present administrative approach taken by the IRS for private ruling purposes is that negotiated cash payments and negative net worth notes which are received from the FSLIC before January 1, 1990, or received pursuant to acquisitions before that date (i.e., payments to which section 597 applies) are treated as received by the financially troubled thrift institution before the acquisition.[37] This treatment results in the following tax consequences. The amount of the cash payment and the fair market value of the negative net worth note are excluded from the income of the financially troubled thrift institution under section 597.[38] If the 50-percent cutback applies, [39] there is a reduction in the tax attributes of the financially troubled thrift institution by 50 percent of the amounts excluded under section 597. The earnings and profits of the financially troubled thrift institution are increased by the amount of the cash payment or the fair market value of the note.[40] Because the increase in earnings and profits is treated as occurring prior to the acquisition of the financially troubled thrift institution, cash payments and negative net worth notes do not affect the basis of the stock of the acquired thrift institution in the hands of the acquirer.

It is also the current administrative approach taken by the IRS for private ruling purposes that, after the acquisition, the reorga-

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[37] *See* LTR 8850051 (September 21, 1988).

[38] If the negative net worth note bears an adequate stated interest rate, the current administrative approach taken by the IRS for private ruling purposes is that the fair market value of the note will be considered equal to its face amount.

[39] *See* footnote 34, *supra*.

[40] *See* LTR 8850051 (September 21, 1988). This treatment of earnings and profits reflects the current administrative approach taken by the IRS for private ruling purposes that a payment from the FSLIC to a financially troubled thrift institution would be taxable as ordinary income to the recipient thrift institution upon receipt in the absence of section 597.

nized thrift institution has a basis in any FSLIC negative net worth note equal to its fair market value. When the reorganized thrift institution receives principal payments from the FSLIC pursuant to the negative net worth note, the thrift institution's basis in the note is reduced (i.e., it recovers its basis) and no income is recognized at that time.

Interest on notes, capital loss payments, yield maintenance payments, and payments of administrative expenses

It is the current administrative approach taken by the IRS for private ruling purposes that interest on negative net worth notes, capital loss payments, yield maintenance payments, and payments of expenses, which are paid by the FSLIC before January 1, 1990, or received pursuant to acquisitions before that date (i.e., payments to which section 597 applies) are treated as received by the reorganized thrift institution when such amounts are paid or accrued under normal tax principles. Ordinarily, such amounts are paid or accrued after the acquisition. This treatment results in the following tax consequences. Such amounts are excluded from the income of the reorganized entity under section 597. If the 50-percent cutback applies,[41] there is a cutback in the tax attributes of the reorganized thrift institution by 50 percent of the amounts excluded under section 597. The earnings and profits of the reorganized thrift institution increase by the amount of such payments.[42] If the stock of the reorganized thrift institution is held by a corporation, and such corporation and the thrift institution file income tax returns on a consolidated basis, the increase in the earnings and profits of the reorganized thrift institution increases the basis of the parent corporation's stock in the thrift institution.[43]

Application of 50-percent cutback in taxable acquisitions [44]

Special rules pertaining to the 50-percent cutback of tax attributes apply in the case of a taxable acquisition of the assets of a financially troubled thrift institution.

The 50-percent cutback of tax attributes does not apply to cash payments made to an acquirer of a financially troubled thrift institution at the time of a *taxable* acquisition.

Rights to receive future payments from the FSLIC in connection with a taxable acquisition (such as yield maintenance payments, payments under guarantees against loss on certain assets, or any other rights) are treated as assets to which basis is allocated. The basis to be allocated to these rights is to reflect the present value, at the time of the acquisition, of the amounts to be received pursuant to these rights. The Treasury Department is authorized to provide rules for basis recovery with respect to such rights. No deduc-

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[41] *See* footnote 34, *supra*.

[42] *See* LTR 8850051 (September 21, 1988).

[43] In addition, the amount of any loss recognized by the thrift institution reduces its earnings and profits and reduces the basis of the parent corporation's stock in the thrift institution.

[44] The following discussion does not apply to acquisitions which would be taxable because of the expiration of the special tax rules for financially troubled thrift institutions. Rather, the discussion concerns acquisitions that have either been structured as taxable transactions or fail to meet the requirements for treatment as a tax-free reorganization, and which receive assistance payments from the FSLIC excluded from income under section 597. (See Part II.B.2. of this pamphlet, *infra*, for a discussion of the applicable requirements for a tax-free reorganization.)

tion for tax purposes is allowed for any basis recovery with respect to such rights in excess of amounts received unless and until such rights finally expire.[45] At that time, a deduction is allowable for the excess, if any, of the amount of basis properly allocated to such rights over the amount of payments actually received pursuant to such rights. Payments received from the FSLIC pursuant to such rights are subject to the 50-percent cutback of tax attributes only to the extent that the amount of such payments exceeds the amount of basis allocated to such rights.

Treatment of particular types of FSLIC assistance after expiration of section 597

Based on the current administrative approach taken by the IRS for private ruling purposes concerning the tax treatment of FSLIC assistance which is excluded from income under section 597,[46] the IRS would presumably treat FSLIC assistance received after the expiration of section 597 as follows. Negotiated cash payments and negative net worth notes received from the FSLIC by a financially troubled thrift institution pursuant to an acquisition generally would be included in the income of the recipient thrift institution before the acquisition. The earnings and profits of the financially troubled thrift institution would increase by the amount of the cash payment or the fair market value of the note. The reorganized thrift institution would have a basis in any FSLIC negative net worth note equal to its fair market value. Likewise, interest paid on negative net worth notes, capital loss payments, yield maintenance payments and any payments of expenses would be included in the income of the recipient thrift institution as such amounts were paid or accrued under normal tax principles. The earnings and profits of the reorganized thrift institution would increase by the amounts of such payments.

2. Tax-free reorganizations

General tax rules

In order for a combination of two corporations to constitute a tax-free reorganization within the meaning of the tax code, a judicially created "continuity of interest" rule must be satisfied. The continuity of interest rule generally requires that the shareholders of an acquired corporation retain a meaningful equity interest in the acquiring corporation.[47] The tax attributes of an acquired corporation, including all its losses, disappear if an acquisition does not qualify as a tax-free reorganization.

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[45] Moreover, deductions for basis recovery which are not in excess of amounts received pursuant to such rights may only offset amounts received from the FSLIC pursuant to such rights, notwithstanding that such amounts are excluded from the income of the recipient thrift institution under section 597. Thus, such deductions may not offset other, taxable, income of the acquired institution or its affiliates.

[46] *See* the discussion in this part of the pamphlet under "Application of section 597 to particular types of FSLIC assistance in tax-free acquisitions."

[47] *See Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 468-470 (1933); Treas. reg. secs. 1.368-1(b) and 1.368-2(a).

Thrift institutions

To facilitate reorganizations of financially troubled thrift institutions, the 1981 Act provided that the continuity of interest rule is met in reorganization transactions involving a thrift institution, even if none of the former shareholders of the acquired thrift institution retains an interest in the acquiring entity, provided certain conditions are met. First, the acquired institution must be a thrift institution. Second, the FHLBB or the FSLIC (or, if neither has supervisory authority, an equivalent State authority) must certify that the thrift institution is financially troubled, i.e., it is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. Third, substantially all the assets of the transferor institution must be acquired by the transferee [48] and substantially all the liabilities of the transferor institution immediately before the transfer, including the liability to depositors, must become liabilities of the transferee. If all these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization under section 368(a)(1)(G).[49] The provision is, in general, effective for acquisitions before January 1, 1990, in taxable years ending before that date.

After expiration of special reorganization rule

After the expiration of the special reorganization rule for financially troubled thrift institutions, it is unclear whether the acquisition of a financially troubled thrift institution could be structured as a tax-free reorganization. Section 368(a)(1)(G) would require that the acquired institution receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization.[50] If the acquisitions of financially troubled thrift institutions could not qualify as tax-free reorganizations, such acquisitions would be taxable. The tax attributes, including the net operating loss carryovers and unused built-in losses of the financially troubled thrift institution, would disappear. If such an acquisition were treated as an acquisition of the assets of the financially troubled thrift institution, the acquirer would assign basis to the assets of the financially troubled thrift institution equal, in the aggregrate, to the purchase price (i.e., the cash paid by the acquirer plus the liabilities assumed). If such an acquisition were treated as an acquisition of the stock of the financially troubled thrift institution, the acquirer would take a basis in the stock of the financially

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[48] The current administrative approach taken by the IRS for private ruling purposes is that "substantially all" the assets of a financially troubled thrift institution in this context means 50 percent of the fair market value of the gross assets of the thrift institution and 90 percent of its operating assets (i.e., all assets except nonperforming assets). This determination is made at the time the thrift institution is certified to be financially troubled. *See* LTR 8850051 (September 21, 1988); LTR 8822049 (March 4, 1988); and LTR 8804008 (October 16, 1987).

[49] Section 368(a)(3)(D).

[50] *But see* LTR 8835057 (June 10, 1988). The IRS has ruled that a transfer of the assets and liabilities of financially troubled banks constitutes a tax-free reorganization under section 368(a)(1)(G), notwithstanding the fact that, at the time the ruling was issued, the special reorganization rule described above did not apply to banks. It is unclear to what extent the IRS will follow this position in the future.

troubled thrift institution equal to the purchase price (i.e., the cash paid by the acquirer).

3. Losses

The financial assistance provided by the FSLIC may compensate for three broad categories of economic losses or expenses attributable to a financially troubled thrift institution: (1) losses of the financially troubled thrift institution that have been recognized before an acquisition, e.g., the excess of the liabilities of the thrift institution over the book basis of its assets; (2) losses that are attributable to the operations of the financially troubled thrift institution which have not yet been recognized, e.g., the difference between the fair market value of the thrift institution's assets and their book bases; and (3) expenses or operating losses that will be incurred by the reorganized thrift institution as a result of acquiring the assets and assuming the liabilities of the financially troubled thrift institution, e.g., losses arising from holding assets yielding interest at below-market rates or expenses of preparing foreclosed property for resale.

As will be discussed below, the tax losses of financially troubled thrift institutions may or may not be subject to limitation after an acquisition depending, in part, upon when and how such losses are recognized for tax purposes. First, losses of a financially troubled thrift institution that have been recognized before an acquisition, such as net operating loss carryovers, may be subject to limitation. Second, under the present administrative approach taken by the IRS for private ruling purposes, losses that are attributable to the operations of a financially troubled thrift institution, but which have not been recognized prior to such thrift institution's acquisition (so-called "built-in" losses or deductions), often may not be subject to limitation. Third, the tax treatment of expenses incurred by a reorganized thrift institution as a result of acquiring the assets and assuming the liabilities of a financially troubled thrift institution, and operating losses which may result therefrom, may also often not be subject to limitation although their precise tax treatment is uncertain. Such losses or expenses may be considered built-in losses or deductions, in which case they often may not be subject to any limitation. On the other hand, if such expenses or losses are not considered built-in losses or deductions, they are not subject to no limitation. As a result, these latter two types of losses may, depending upon the IRS interpretation of present law, generally be used to offset future taxable income of the reorganized thrift institution or to offset the taxable income of the thrift institution's parent (or other members of the same consolidated group).

In many cases, taxpayers may decide when to recognize, for tax purposes, an economic loss that has already occurred. Depending on when a loss is recognized for tax purposes, it may be treated as a net operating loss carryover, a built-in loss, or an operating loss. For example, consider a financially troubled thrift institution which has as its only asset a mortgage paying a below-market rate of interest (which, therefore, has a fair market value less than its adjusted basis) but has deposits on which it pays a market rate of interest. The economic loss inherent in the mortgage asset can be recognized in one of three ways. First, if the thrift institution sells

the mortgage before an acquisition, the financially troubled thrift institution recognizes a loss, resulting in a net operating loss carryover (assuming the financially troubled thrift institution has no income against which to offset the loss). If the acquisition qualifies as a tax-free reorganization, the tax attributes of the financially troubled thrift institution, including its net operating loss carryover, would (subject to possible limitations) carry over to the reorganized thrift institution. Second, if the reorganized thrift institution sells the mortgage after the acquisition, the reorganized thrift institution would recognize a built-in loss. Third, if the reorganized thrift institution retains the mortgage, it will recognize operating losses over the life of the mortgage equal to the difference between the interest paid on the deposits assumed from the financially troubled thrift institution and the interest received on the mortgage. Although unclear these operating losses may be considered built-in losses or deductions.

a. Limitations on net operating loss carryovers

In general, tax-free acquisitions of financially troubled thrift institutions on or before December 31, 1989, are granted more favorable tax treatment with respect to the loss limitation rules of section 382 than that generally allowed to other financially troubled corporations. For acquisitions after December 31, 1989, the strict loss limitation rules of section 382 will be applicable to the tax-free reorganization of *all* financially troubled corporations, including financially troubled *thrift* institutions.

General tax rules applicable to reorganizations not involving financially troubled thrift institutions

In a tax-free reorganization, the acquiring corporation generally succeeds to the tax attributes of the acquired corporation, including its net operating loss carryovers, subject to certain limitations contained in section 382. In general, under section 382, the ability of an acquiring corporation to succeed to the net operating loss carryovers of a corporation acquired in a tax-free reorganization is limited if there has been more than a 50-percent change in the ownership of the corporation entitled to use such losses (an "ownership change").

If there has been an ownership change of the corporation that was entitled to use the losses before the ownership change (an "old loss corporation"), the amount of the taxable income of the surviving corporation which may be offset by "pre-change losses" may not exceed the value of the old loss corporation multiplied by the long-term tax-exempt rate (the "section 382 limitation"). Pre-change loss means, in general, the net operating loss carryovers of the old loss corporation and the portion of the net operating loss of the old loss corporation in the taxable year of the ownership change which is allocable to the period before the ownership change.

Limitations under section 382 on so-called "built-in losses" of an acquired corporation also may apply if there has been an ownership change. Built-in losses are, in general, the excess of the aggregate adjusted bases of a corporation's assets over the fair market value of such assets, as calculated immediately before an owner-

ship change.[51] Recognized built-in losses are subject to limitation under section 382 if, immediately before an ownership change, the amount of such losses exceeds 25 percent of the fair market value of the assets (the "25-percent threshold").[52]

More favorable tax rules apply to the tax-free reorganization of certain financially troubled *non-thrift* corporations than to corporations generally. In general, the loss limitation rules of section 382 do not apply to ownership changes of certain financially troubled corporations if the shareholders and creditors of the acquired corporation own, immediately after the ownership change, stock of the reorganized entity possessing at least 50 percent of the total voting power and value of the stock of such corporation.

Financially troubled thrift institutions

Applicability of loss limitations

In the case of a tax-free acquisition on or before December 31, 1989, of a financially troubled thrift institution under the special reorganization rules described above, the depositors of a financially troubled thrift institution whose deposits are assumed by the acquiring corporation are deemed to continue an equity interest in the reorganized thrift institution. In addition, the percentage ownership that must be retained so as not to trigger the application of the limitations on losses under section 382 is reduced from 50 percent to 20 percent. Thus, the loss limitation rules of section 382 do not apply if the depositors and creditors of the acquired financially troubled thrift institution own at least 20 percent of the aggregrate of (1) the value of the stock of the reorganized thrift institution plus (2) the deposits in the reorganized thrift institution (the "20-percent test") (sec. 382(l)(5)(F)).[53] In many instances, an acquirer may utilize one or more separate acquisition subsidiaries to structure the acquisition in a manner intended to prevent the application of the 20 percent test. In some cases, this may be unfeasible or undesirable.

For ownership changes after December 31, 1989, the stricter general tax rules described above applicable to the net operating loss carryovers of all financially troubled corporations would apply to the tax-free reorganization of a financially troubled thrift institution.[54] In such cases, the loss limitation rule of section 382 would not apply to an ownership change of a financially troubled thrift institution if the shareholders and creditors of the acquired corporation immediately before the ownership change owned, immediately after the ownership change, stock of the reorganized entity possessing at least 50 percent of the total voting power and value of the stock of such corporation.[55]

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[51] A built-in loss also includes certain deductions of an old loss corporation attributable to periods before the ownership change.

[52] Except as may be provided in Treasury regulations, cash and marketable securities are excluded from this computation.

[53] *See, e.g.*, LTR 8850062 (September 22, 1988) and LTR 8850051 (September 21, 1988).

[54] After the expiration of the special reorganization rule for financially troubled thrift institutions (discussed in Part II.B.2. of this pamphlet), it is possible that a reorganization of a financially troubled thrift institution could not be structured as a tax-free reorganization. In such a case, there would be no net operating loss carryover and the net operating losses of the financially troubled thrift institution would disappear upon a reorganization of that institution.

[55] If a thrift institution is not financially troubled, the general rules applicable to all taxpayers, discussed above, will apply.

Built-in losses

If the tax-free reorganization of a financially troubled thrift institution fails the 20-percent test with respect to an ownership change on or before December 31, 1989, or if a reorganization after December 31, 1989 fails to meet the stricter loss limitation rules of section 382 applicable to the reorganization of financially troubled corporations, the limitations of section 382 apply with respect to net operating loss carryovers. There will be no limitation on the built-in losses of the reorganized thrift institution, however, unless the 25-percent threshold for such losses is met. As indicated above in Part II.B.1. of this pamphlet, the present administrative approach taken by the IRS for private ruling purposes is that a negative net worth note is considered, for purposes of making this determination, as an asset of a financially troubled thrift institution before the ownership change with a fair market value and an adjusted basis generally equal to its face amount. In addition, under the current administrative approach taken by the IRS for private ruling purposes, the fair market value of the assets of a financially troubled thrift institution before an ownership change has been interpreted to mean the value of such assets as guaranteed by the FSLIC. As a result, the built-in losses of a financially troubled thrift institution often will not meet the 25-percent threshold, and thus often will not be subject to limitation under the generally applicable rules of section 382 even if a change in ownership is deemed to occur. The application of this rule may be illustrated by the example below.

Example.—A financially troubled thrift institution is acquired in a tax-free reorganization in December 1988. The 20-percent test is not met and, consequently, the reorganized thrift institution is subject to the loss limitations of section 382. The troubled thrift institution has liabilities of $200 and one operating asset with an adjusted basis and book value of $100 and a fair market value of $60 (i.e., it has a built-in loss of $40). The FSLIC provides a negative net worth note with a face amount of $100 and guarantees the thrift institution against a loss in excess of $10 on the disposition of the operating asset (i.e., the FSLIC guarantees that the thrift institution will receive at least $90 upon the disposition of the asset).

Under the current administrative approach taken by the IRS for private ruling purposes, the aggregrate adjusted bases of the assets of the troubled thrift institution is $200 (negative net worth note of $100 and an operating asset of $100). The fair market value of such assets is $190 (a negative net worth note worth $100 and an operating asset worth $90). The excess of the aggregrate adjusted bases of the thrift institution's assets over the fair market value of such assets ($10) is 5 percent of the fair market value of such assets ($10/$200). Since the 25-percent threshold is not met, the limitations of section 382 do not apply to the $40 built-in loss of the reorganized thrift institution.

b. Other limitations on losses (SRLY limitation)

Other than the special rules of section 382 discussed immediately above, there are no special rules applicable only to thrift institutions in connection with limitations on losses. The limitation on losses described herein applies generally to all taxpayers. Following

a general discussion of this limitation, however, is a discussion of how this limitation on losses may apply to limit the use of the losses of a financially troubled thrift institution. In particular, if the acquired thrift institution files income tax returns with other corporations on a consolidated basis, additional loss limitation rules promulgated by the Treasury Department pursuant to its authority to issue regulations concerning the filing of consolidated tax returns may apply.

General tax rules

In general, groups of corporations that are connected through the ownership of stock possessing at least 80 percent of the vote and the value of other members of the group (a "consolidated group") may elect to file a single, consolidated income tax return. The consolidated tax return measures the taxable income of the consolidated group as a whole and imposes a corporate tax on its aggregrate taxable income. Losses of one member of a consolidated group can, in general, offset the income of other members of the same consolidated group. Pursuant to regulations issued by the Treasury Department, however, a net operating loss or net capital loss of a member of a consolidated group that was recognized prior to the time that that corporation became a member of that consolidated group can, in general, offset the combined taxable income of the consolidated group ("consolidated taxable income") only to the extent that such member contributed to consolidated taxable income.[56] This rule is known as the separate return limitation year limitation (the "SRLY limitation"). The SRLY limitation was intended to prevent a corporation with net operating loss carryovers and carrybacks from being brought into a consolidated group with profitable members so that such losses could offset the income of the income-producing members of the group. As a practical matter, it may be possible to avoid the intended effect of the SRLY limitation. For example, income-producing assets or business opportunities of profitable members of a consolidated group might be placed within or directed to a consolidated group member with loss carryovers subject to the SRLY limitation, thereby increasing its income. As another example, a corporation with taxable income might be merged into a consolidated group member with loss carryovers subject to the SRLY limitation, in which case the income of the member with the losses subject to the SRLY limitation may be measured by the income of the combined entity.[57]

The SRLY limitation may also apply to "built-in deductions" of members of a consolidated group. A built-in deduction generally means those deductions or losses of a corporation which are recognized in a year in which the corporation is a member of a consolidated group but which economically accrued in a taxable year in

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[56] Treas regs. secs. 1.1502-21(c) and 1.1502-22(c).

[57] In some circumstances, section 269 may impose certain timing, structuring or other limitations on the acquirer's ability to combine income-producing assets with losses of an acquired subsidiary. *See, e.g.*, Treas. regs. sec. 1.269-3(b) and (c) and section 269(b). In addition, the income of a corporation attributable to built-in gain may not, in general, be offset by the preacquisition losses of another corporation (sec. 384).

which the corporation was not a member of that group.[58] Built-in deductions are not, however, subject to the SRLY limitation if, immediately before the corporation becomes a member of the group, the aggregate adjusted basis of all the assets of such member (other than cash, marketable securities, and goodwill) does not exceed the fair market value of all such assets by more than 15 percent (the "15-percent threshold").[59]

Thrift institutions

If a troubled thrift institution becomes a member of a consolidated group of corporations, the net operating losses and net capital losses of that thrift institution that were recognized prior to becoming a member of the consolidated group are subject to the SRLY limitation. Thus, to the extent the SRLY rules are effective, the net operating losses and net capital losses of an acquired financially troubled thrift institution that were recognized prior to that thrift institution becoming a member of a consolidated group can be used only to the extent that the financially troubled thrift institution has taxable income.

As indicated above, there is no SRLY limitation on the built-in deductions of a financially troubled thrift institution that becomes a member of a consolidated group unless the 15-percent threshold for such deductions is met. In making this determination, as in the case of the 25-percent threshold for built-in losses under section 382, the present administrative approach taken by the IRS for private ruling purposes is that a negative net worth note is considered an asset of a financially troubled thrift institution before it becomes a member of a consolidated group with a fair market value and a basis generally equal to its face amount. In addition, the fair market value of the assets of a financially troubled thrift institution before it becomes a member of a consolidated group includes the value of such assets as guaranteed by the FSLIC. As a result, a reorganized thrift institution often may not meet the 15-percent threshold, and thus its built-in deductions often may not be subject to the SRLY limitation.

4. Examples of the application of present law tax rules to a reorganization of a financially troubled thrift institution

The above rules are illustrated in the following examples.

Example 1

A financially troubled thrift institution is acquired in a tax-free reorganization in December 1988. The reorganized thrift institution fails the 20-percent test, so the loss limitation rules of section 382 apply to the acquisition. The financially troubled thrift did not have a net operating loss carryover prior to the reorganization.

The acquirer and the reorganized thrift institution file consolidated tax returns. The thrift institution has two assets: (1) a parcel of real estate acquired through foreclosure with a fair market

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[58] Treas regs. sec. 1.1502-15. A built-in deduction includes, among other items, capital losses which have accrued but have not been economically realized and depreciation deductions attributable to the excess of the basis of an asset over its fair market value.

[59] Treas. regs. sec. 1.1502-15(a)(4)(i)(*b*).

value of $60 and an adjusted basis and book value of $100; and (2) a mortgage of $100 which yields 8-percent interest with an adjusted basis and book value of $100 and a fair market value of $80. The thrift institution issued a $250 certificate of deposit ("CD," a liability) on which it pays 10-percent interest. Book net worth is negative $50 ($100 real estate asset plus $100 mortgage asset less $250 CD liability).

The FSLIC provides the following financial assistance. First, the FSLIC contributes a negative net worth note with a face amount of $50 to bring the book net worth of the thrift institution up to zero. The negative net worth note yields interest of 10 percent annually. Second, the FSLIC guarantees the reorganized thrift institution against any loss on the disposition of the real estate (i.e., the FSLIC guarantees that the thrift institution will receive at least $100 upon the disposition of the asset). Third, the FSLIC guarantees that the mortgage of the thrift institution will yield a return of 11 percent. A $100 mortgage yielding 11-percent interest has a fair market value of $100. The acquirer agrees to contribute $5 to the capital of the thrift institution, and takes a basis of $5 in its stock.

In the taxable year following the acquisition, the thrift institution sells the real estate for $60, the mortgagor makes a payment of $8 to the thrift institution and the thrift institution pays $25 to the holder of the CD. The FSLIC, pursuant to the capital loss and yield maintenance guarantees, makes a $40 capital loss payment ($100 less $60), and a $3 yield maintenance payment ($100 times the excess of 11 percent over 8 percent) to the thrift institution. The FSLIC also remits $5 interest ($50 times 10 percent) to the thrift institution pursuant to the negative net worth note.

The thrift institution has a loss of $57 for Federal income tax purposes (see table, below). Forty dollars of the loss is attributable to loss on the sale of the real estate and $17 of the loss is attributable to the difference between the $25 interest paid and $8 interest received. The $48 in assistance payments made by the FSLIC is excluded from the income of the thrift institution under section 597. The earnings and profits of the thrift institution are reduced by $9 and the acquirer's basis in the stock of the thrift institution is reduced to $0. The $4 loss in excess of basis ($9 minus $5) creates an excess loss account ("ELA") of $4.[60]

POST-ACQUISITION OPERATING RESULTS

Item	Earnings and profits	Taxable income
Loss from sale of real estate	−$40.00	−$40.00
Interest income	8.00	8.00
Interest expense	−25.00	−25.00
Capital loss payment	40.00	0
Yield maintenance payment	3.00	0
Interest on negative net worth note	5.00	0
Total	−9.00	−57.00

[60] The ELA is included in the acquirer's income upon certain dispositions of the stock of the thrift institution. Treas. reg. sec. 1.1502-19.

Thus, the reorganized thrift institution has a tax loss of $57 notwithstanding the fact that it has suffered an economic loss of only $9 (since the FSLIC provided tax-free assistance of $48). There is no cutback in the tax attributes of the reorganized thrift institution because the cutback does not apply to transfers pursuant to acquisitions occurring before January 1, 1989.

Forty dollars of the $57 loss (that portion of the loss attributable to the sale of the real estate) is a recognized built-in loss for purposes of section 382 and a built-in deduction for purposes of the SRLY limitation. However, neither of these limitations applies because neither the 25-percent threshold for built-in losses in section 382 nor the 15-percent threshold for built-in deductions under the SRLY rule is met. The aggregate adjusted bases of all the assets of the thrift institution ($250) does not exceed the fair market value of all such assets as guaranteed by the FSLIC ($250). Thus, section 382 does not apply to limit the use of the $40 loss and it may offset future taxable income of the reorganized thrift institution. Likewise, the SRLY limitation does not apply to limit the use of such loss and it may offset the taxable income of the reorganized thrift institution's parent or other members of the same consolidated group.

Tax benefits.—If the interest on the negative net worth note, capital loss payments and yield maintenance payments were subject to income tax (rather than excluded under section 597), the tax loss of the acquired institution would have been $9 rather than $57, and the tax benefit to the acquiring corporation, at a 34-percent corporate tax rate, would have been $3.06 (34 percent of $9) rather than $19.38 (34 percent of $57). Thus, the current administrative approach taken by the IRS for private railing purposes, the tax benefit from the exclusion of the FSLIC assistance payments of $48 amounts to $16.32 ($19.38 minus $3.06).[61]

In assisted acquisitions, however, the acquirer frequently is required to share some or all of these tax benefits with the FSLIC. For example, if the FSLIC is entitled to one-half of the tax benefits, then the acquirer would retain one-half of the $16.32 tax benefit, or $8.16. Thus, under the assumptions of this example, the net tax benefit of the acquirer in the first year of ownership ($8.16) would exceed the value of cash and property contributed to the thrift institution by the acquirer ($5.00).[62] In some instances, the acquirer

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[61] If the acquirer were subject to the alternative minimum tax, deductions would be utilized at a 20 percent tax rate (rather than 34 percent). In such a case, the amount of income subject to the alternative minimum tax may differ under these facts. *See* Part II.B.6. of this pamphlet, *infra*, for a discussion of the alternative minimum tax.

[62] According to one study, "in practice, almost all of the supposed capital contributed by investors in these transactions [FHLBB Southwest Plan assisted acquisitions] was recovered immediately from tax benefits." *See* testimony of Lowell Bryan of McKinsey & Company, Inc., before the Senate Committee on Banking, Housing, and Urban Affairs, on January 31, 1989, p. 8. It is not clear to what extent, if any, other aspects of the negotiated agreements may mitigate this result.

may be required to reinvest all or a portion of this tax benefit in the acquired thrift institution.

Sales at a lower price.—As a result of these tax benefits and the guarantees provided by the FSLIC, the acquirer may not have an incentive to sell the thrift institution's assets for as high a price as possible because tax benefits may be maximized at a lower sales price. For example, if the acquirer in this Example above had caused the thrift institution to sell its real estate asset for $10 rather than $60, the tax loss of the thrift institution would have been $107 rather than $57, while the economic loss would have remained unchanged at $9 as a result of the capital loss guarantee (see table, below).

POST-ACQUISITION OPERATING RESULTS: REAL ESTATE SOLD FOR $10 INSTEAD OF $60

Item	Earnings and profits	Taxable income
Loss from sale of real estate	−$90.00	−$90.00
Interest income	8.00	8.00
Interest expense	−25.00	−25.00
Capital loss payment	90.00	0
Yield maintenance payment	3.00	0
Interest on negative net worth note	5.00	0
Total	−9.00	−107.00

In this case, the tax benefit to the acquirer in the first taxable year would be $33.32 (34 percent of the $98 of excluded FSLIC payments), of which $16.66 would be retained by the acquirer under a 50-percent sharing agreement with the FSLIC. By selling off the thrift institution's assets at a lower price (i.e., at $10 as opposed to $60) the acquirer is able to increase the tax benefits from $8.16 to $16.66 without incurring any additional economic loss. In general, if the marginal dollar of loss is 100-percent guaranteed, and the acquirer is permitted to retain some portion of tax benefits, then there may be a tax incentive to generate deductible losses by selling thrift institution assets at lower amounts.

Provisions in the assistance agreement between the FSLIC and the acquirer may hinder the disposition of assets at below market prices. For example, the assistance agreement might encourage the acquirer to hold the asset for at least some period of time, rather than selling it immediately into a troubled market, by providing a guaranteed yield on the asset that is higher in the earlier years following the acquisition and that declines over time. The assistance agreement also may grant the FSLIC certain rights to review the acquirer's planned disposition of certain assets or may grant the ac-

quirer rights to share in a portion of the gain realized upon the disposition of certain assets above a certain amount.[63] However, because of the difficulties in determining fair market value, it may be difficult for the FSLIC to effectively monitor asset sales to assure that the highest possible price is obtained. The effectiveness of a gain-sharing agreement to provide an incentive for the acquirer to sell thrift institution assets at a higher price would depend on the amount of gain-sharing benefits attributable to selling at a high price relative to the amount of additional tax benefits attributable to selling at a low price.

Example 2

The facts are the same as in Example 1 above, except that the financially troubled thrift institution also has a net operating loss carryover of $20 on the date of the reorganization.

The results are the same as in Example 1 except that the net operating loss is subject to both the limitations of section 382 and the SRLY limitation. Since the value of the stock of the financially troubled thrift institution (the old loss corporation) is zero (in fact, it had a negative net worth before the FSLIC contribution), no part of the $20 net operating loss of the financially troubled thrift institution may be used to offset income of the reorganized thrift institution under section 382.

Even in cases where an acquired financially troubled thrift institution did have value, so that some portion of its net operating losses were available, the SRLY limitation would generally apply and prevent the net operating losses from being used to offset the income of the other members of the reorganized thrift institution's consolidated group. However, in some circumstances, the SRLY limitations may be avoided.

Example 3

The facts are the same as in Example 1 above, except that the acquisition occurs in January, 1989. There is a cutback of $24 (50 percent of $48 of FSLIC assistance) in the tax attributes of the reorganized thrift institution, as follows. There is no cutback in the net operating losses of the reorganized thrift institution because the institution has no net operating loss carryforward. The current $25 interest deduction of the reorganized thrift institution is reduced to $1. Thus, the reorganized thrift institution has a tax loss of $33, which it can use either to offset its own future taxable income or to offset the taxable income of its parent (or other members of the same consolidated group).

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[63] For example, the assistance agreement might provide that, upon the disposition of an asset, the acquirer may be entitled to additional assistance in an amount equal to 10 percent of the proceeds in excess of 50 percent of the book value of the asset. Assume a thrift institution asset with a book value of $100 is fully guaranteed from capital loss by the FSLIC and a "gain-sharing" provision as described above also applies to the asset. If the asset is sold for $60, the acquirer would be entitled to $41 of FSLIC assistance. Forty dollars of the $41 assistance is from the capital loss guarantee ($100 guarantee less $60 proceeds). The remaining $1 is from the gain sharing arrangement (10 percent times ($60 less ($100 times 50 percent))).

5. Exemption from recapture for certain distributions to the FSLIC

In general, when a savings and loan association or a mutual savings bank makes a distribution to its shareholders out of excess bad debt reserves (i.e., in general, the excess of the reserve for losses on qualifying real property loans over the reserve which would have been allowable under the experience method), it must report that amount as income (sec. 593(e)). This recapture rule does not apply, however, to distributions to the FSLIC in redemption of an interest in a thrift institution received in exchange for financial assistance.

6. Alternative minimum tax

Taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a rate of 20 percent (in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences.[64] For tax years 1987 through 1989, 50 percent of the excess of pre-tax book income of a corporation (generally, the amount of net income set forth on the corporation's financial statements) over its alternative minimum taxable income is an adjustment. For taxable years beginning after 1989, 75 percent of the excess of a corporation's adjusted current earnings (generally, a variation of a corporation's earnings and profits) over its alternative minimum taxable income is an adjustment.[65]

Certain FSLIC assistance amounts are treated as income for book purposes and as an increase in earnings and profits,[66] which can result in subjecting a corporation or consolidated group to or increasing a corporation's or consolidated group's alternative minimum tax liability. For example, assume a financially troubled thrift institution owns an asset with a basis of $100 and a fair market value of $60, and has liabilities of $100. The thrift institution is acquired in a tax-free reorganization in December 1988, with the FSLIC providing a capital loss guarantee of $100 with respect to the asset. In January 1990, the thrift disposes of the asset for $60. Pursuant to the guarantee, the FSLIC contributes $40 to the

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[64] In the case of thrift institutions, the amount by which the deduction for an addition to a bad debt reserve exceeds the amount that would have been allowable had the institution maintained its bad debt reserve based on the experience method, is considered a preference (sec. 57(a)(4)).

In addition, the amount of a net operating loss deduction that can be used by a taxpayer in any one year to offset alternative minimum taxable income is limited to 90 percent of alternative minimum taxable income (sec. 56(d)(1)).

[65] In determining adjusted current earnings, an adjustment must be made in the case of a corporation that has experienced a change of ownership (within the meaning of sec. 382) after October 22, 1986, where the aggregate adjusted bases of the assets of such corporation exceed the value of the corporation's stock (properly adjusted for liabilities and other relevant items). In such case, the adjusted basis of each asset of the corporation is equal to its proportionate share (based on relative fair market values) of the value of the corporation's stock (adjusted as described above)(sec. 56(g)(4)(H)).

In addition, no loss is allowed in the determination of adjusted current earnings on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities (sec. 56(g)(4)(E)). *See* Part II.C.1. of this pamphlet, *infra*.

[66] *See* Part II.B.1. of this pamphlet, *supra*.

thrift institution, which is excludable from gross income under section 597. The thrift institution has a loss for regular tax purposes of $40 ($60 proceeds less $100 basis). However, the amount of the loss for purposes of the alternative minimum tax is only $10, because the FSLIC assistance constitutes earnings and profits and thus will increase the thrift institution's adjusted current earnings, resulting in an adjustment of $30 (75 percent of $40). Therefore, if the thrift institution (or the consolidated group of which the thrift institution is a member) is subject to the alternative minimum tax, the full benefit of the section 597 exclusion for the $40 of FSLIC assistance will not be realized.

C. Other Tax Rules of Significance to Thrift Institutions

1. Realization of tax losses on loan swaps

Many thrift institutions have engaged in transactions known as "mortgage swaps" or "reciprocal sales." In such transactions, a thrift institution combines mortgage loans of the same type and with the same below current market interest rates into a pool. The entire pool of loans, or a substantial interest in the pool (usually 90 percent), is swapped with another entity for a similar loan pool (or interest therein). These transactions generally have been structured as sales, with cash actually passing between the parties, although the amount of cash tendered by each party is virtually identical. The amount of cash exchanged is less than the aggregate face amounts of the mortgages because the value of the mortgages has declined significantly as a result of increases in market interest rates.

FHLBB Memorandum R-49 (June 27, 1980) provides regulatory accounting rules for mortgage swaps. If certain enumerated criteria are met, no losses are reportable for regulatory accounting purposes as a result of these transactions.[67] In addition, losses from mortgage swaps generally are not reportable for financial accounting (book) purposes. Notwithstanding this treatment for regulatory and financial accounting purposes, thrift institutions that have engaged in these transactions have claimed losses for Federal income tax purposes.[68] These tax losses often have been carried back in order to obtain refunds of taxes paid in previous years.[69]

The IRS has ruled that these transactions do not result in a deductible loss because the thrift institution merely has exchanged

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[67] Memorandum R-49 provides, in pertinent part, that the swapped mortgages must: (1) involve only single family residential mortgages; (2) be of similar type (*e.g.*, a swap of conventional mortgages for other conventional mortgages); (3) have the same stated terms to maturity; (4) have identical stated interest rates; (5) have similar remaining terms to maturity; (6) have aggregate principal amounts within the lesser of 2 1/2 % or $100,000 (plus or minus) on both sides of the swap, with any additional consideration being paid in cash; (7) be sold without recourse; (8) have similar fair market values; (9) have similar loan-to-value ratios at the time of the swap; and (10) have all security properties for both sides of the swap in the same state.

[68] For purposes of computing alternative minimum tax liability for tax years beginning after 1989, no loss is allowed in the determination of adjusted current earnings on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities (sec. 56(g)(4)(E)). As discussed above, losses on mortgage swaps are not reportable for book purposes, which affects computation of alternative minimum tax liability for tax years 1987 through 1989. *See* Part II.B.6. of this pamphlet, *supra*, for a discussion of the alternative minimum tax.

[69] *See* Part II.A.2. of this pamphlet, *supra*, for a discussion of the taxable years to which losses of thrift institutions may be carried back and carried forward.

one mortgage pool for another mortgage pool not differing materially either in kind or in extent and because the swap has no significant economic purpose apart from the anticipated tax consequences.[70] However, the mortgage swap cases that have been litigated thus far, while not uniform in result, generally have permitted the deductibility of losses from mortgage swaps.[71]

2. Amortization of core deposit intangibles

Amortization of an intangible business or investment asset is allowable if the asset has a limited useful life which can be determined with reasonable accuracy and has an ascertainable value separate and distinct from goodwill. Goodwill (generally, the expectancy of continued patronage) can not be depreciated or amortized (Treas. regs. sec. 1.167(a)-3).

The acquirer of a depository institution in a taxable acquisition sometimes pays a premium over book value for the institution's assets. Rather than allocating the entire premium to nonamortizable goodwill, some acquirers have allocated all or a substantial part of the premium to the institution's "core deposit base," an intangible asset for which they have claimed amortization deductions. The position of the IRS is that the value of the core deposits arises from the institution's continued relationship with depositors, i.e., the core deposits are merely goodwill and nonamortizable. Taxpayers, often using elaborate accounting studies, have contended that these core deposits represent a low cost source of funds that have a value separate and distinct from goodwill. The courts that have considered whether customer deposit base is amortizable have reached different conclusions.[72]

The issue of allocating purchase price (including any premium paid over book value) to assets generally arises only in taxable acquisitions. Although most acquisitions of financially troubled thrift institutions previously have been structured as tax-free reorganizations, more acquisitions may be structured as taxable transactions in the future.

3. Sale of tax losses through special-purpose subsidiaries

A financially troubled thrift institution which cannot generate income within its consolidated group sufficient to realize the full benefit of its available losses may form a special-purpose subsidiary which in turn issues adjustable rate preferred stock. Such a trans-

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[70] *See* Rev. Rul. 81-204, 1981-2 C.B. 157; Rev. Rul. 85-125, 1985-2 C.B. 180.

[71] *See Centennial Savings Bank, FSB v. United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), *appeal docketed*, No. 88-1297 (5th Cir. June 29, 1988)(for Government); *First Federal Savings & Loan Ass'n of Temple v. United States*, 694 F. Supp. 230 (W.D. Tex. 1988), *appeal docketed*, No. 88-1723 (5th Cir. Dec. 19, 1988) (for taxpayer); *San Antonio Savings Ass'n v. Comm'r*, 55 T.C.M. (CCH) 813 (1988)(for taxpayer); *Federal National Mortgage Association v. Comm'r*, 90 T.C. 405 (1988)(for taxpayer); *Cottage Savings Association v. Comm'r*, 90 T.C. 372 (1988)(for taxpayer).

[72] *See AmSouth Bancorporation v. United States*, 681 F. Supp. 698 (N.D. Ala. 1988)(for Government); *Citizens & Southern Corp. v. Comm'r*, 91 T.C. No. 35 (1988) (for taxpayer). *See also Southern Bancorporation, Inc. v. United States*, 847 F.2d 131 (4th Cir. 1988) and *Banc One Corp. v. Comm'r*, 84 T.C. 476 (1985), *aff'd*, 815 F.2d 75 (6th Cir. 1987) (both courts denied the deduction, based on the taxpayers' failure to properly establish a useful life for the asset; neither court decided whether the deposit base was an asset separate and distinct from goodwill).

action may effectively enable the thrift institution to sell its losses to other taxpayers.[73]

In these transactions, the financially troubled thrift institution (or another member of its consolidated group) forms a subsidiary in which it owns all the common stock. Profitable corporations purchase adjustable rate preferred stock in the subsidiary. The only assets of the newly formed subsidiary are very secure assets, such as high quality debt obligations (e.g., Treasury securities) which are either contributed by the financially troubled thrift institution or purchased by the subsidiary with the proceeds of the preferred stock issuance. If the transaction is properly structured, the following tax results may occur. The tax treatment of these transactions has not been specifically addressed in any public guidance issued by the IRS.

The financially troubled thrift institution and the special-purpose subsidiary file income tax returns on a consolidated basis. The interest income earned on the debt obligations held by the subsidiary can be offset by the losses generated by the financially troubled thrift institution. In addition, the interest income earned by the subsidiary increases its earnings and profits, even if the financially troubled thrift institution would have no earnings and profits if it held the debt obligations directly. As a result, the subsidiary will have sufficient earnings and profits to pay out as a dividend on the preferred stock a portion of the interest income it earns on the debt obligations. The recipient corporation includes the dividend in income but is allowed a deduction equal to 70 percent of the amount received as a dividend (sec. 243).[74]

The favorable tax results of such a transaction are illustrated by the following example.

Example.—Profitable corporation ("Corporation") is considering investing $100 million in Treasury securities paying 9 percent interest. If Corporation purchases those securities outright, it receives $9 million of interest income each year. Assuming Corporation is taxable at a 34 percent rate, it pays Federal income tax of $3.06 million ($9 million times 34 percent) and retains $5.94 million on an after-tax basis ($9 million minus $3.06 million).

Instead, Corporation purchases $100 million of adjustable rate preferred stock in a special-purpose subsidiary ("Subsidiary") set up by a financially troubled thrift institution ("Thrift"). Subsidiary and Thrift file consolidated returns. Subsidiary uses the funds contributed by Corporation for the preferred stock to purchase $100 million in Treasury securities paying 9 percent interest. Subsidiary has $9 million of interest income each year but pays no tax because such income is offset by the losses of Thrift. Subsidiary pays $7 million to Corporation as a dividend on Corporation's preferred stock.

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[73] Financially troubled taxpayers other than thrift institutions may also use such special-purpose subsidiaries. As of June 30, 1988, approximately $7.1 billion of preferred stock had been issued publicly by special-purpose subsidiaries of thrift institutions. Of the total of $3.5 billion of special-purpose subsidiary preferred stock issues in the first half of 1988, 24 percent was issued by thrift institutions, 37 percent by finance companies, and 6 percent by commercial banks. *See* Morgan Stanley, "Impact of House Ways and Means 1988 Technical Corrections Act Proposals Relating to Dividends Received Deduction," July 11, 1988.

[74] For a fuller discussion of the tax issues involved in the use of special-purpose subsidiaries, *see* Jassy, "Issuances of Floating Rate Preferred Stock by Special Purpose Subsidiaries of Loss Corporations," 39 *Tax Lawyer* (No. 3) 518 (1986).

Corporation has $7 million of dividend income but is allowed a dividends received deduction of $4.9 million (70 percent of $7 million). Assuming Corporation is taxable at a 34 percent rate, it pays Federal income tax of $.714 million (34 percent of ($7 million minus $4.9 million)). Corporation retains $6.286 million on an after-tax basis ($7 million minus $.714 million).

In effect, Thrift has sold the tax benefit of its losses to Corporation. Corporation receives an additional $.346 million as a result of the transaction with Subsidiary ($6.286 million minus $5.94 million). Subsidiary (and Thrift) receive $2 million ($9 million interest from Treasury securities minus $7 million dividend payment to Corporation) in exchange for the use by Corporation of $9 million of losses.[75] Note that Thrift will engage in this transaction only if Thrift does not have sufficient income to absorb its losses; if Thrift had sufficient income, the losses would be worth $3.06 million (34 percent times $9 million) to Thrift.

[75] Assuming Thrift could not have otherwise used its losses, tax revenues to the Treasury have decreased by $2.346 million ($3.06 million minus $.714 million).

III. ISSUES IN PROVIDING ASSISTANCE TO THE THRIFT INDUSTRY THROUGH THE TAX SYSTEM

A number of issues are relevant in evaluating tax incentives that are intended to provide assistance to deposit insurers (i.e, the FSLIC or the FDIC) or to troubled financial institutions. Those considerations include: the cost efficiency of tax incentives; the effect of such incentives on the fairness of the tax system; the impact of such incentives on the operations of the deposit insurer; and Federal budget issues.

A. Cost Efficiency of Tax Incentives

In general

One issue is whether tax incentives are an efficient way to provide Federal assistance to the deposit insurer or to troubled financial institutions. Cost efficiency refers to the relative amount of benefits received by the intended beneficiary of the incentive (e.g., the deposit insurer or troubled financial institutions) compared with the revenue loss to the Treasury from the incentive. There are basically three reasons why tax incentives may be less efficient than direct outlay expenditures to the Government.

Sharing of tax benefits

First, tax incentives provide a benefit only if they reduce the taxes payable by a taxable entity. In the case where the tax benefit is intended to benefit a tax-exempt entity (such as the FSLIC, the FDIC, or a troubled financial institution that is effectively exempt from tax because of its net operating loss deductions), benefits can accrue to the tax-exempt entity only if the tax benefits are given to a taxable entity in connection with transactions between the tax-exempt entity and a taxable entity. Typically, a taxable entity will not adjust the price of such a transaction by the full amount of the tax benefit it receives. Instead the taxable entity will share the tax benefit with the tax-exempt entity. Thus, the benefit accruing to the tax-exempt entity will be less than the total tax benefits arising from the transaction.[76]

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[76] *See* supplement of January 9, 1989, to testimony of M. Danny Wall, Chairman of the FHLBB, in which the FHLBB estimated that there were $3,985.8 million of tax benefits associated with the reorganizations of thrift institutions occurring in December 1988, and that the FSLIC received an estimated $1,975.9 million (or 49.6%) of such benefits.

See also *Analysis of Safe-Harbor Leasing* (JCS-23-82, June 14, 1982), where a study of safe-harbor leases by the Staff of the Joint Committee on Taxation indicated that the efficiency of safe-harbor leases varied from approximately 60 percent to 80 percent depending upon the size of the transactions and when the transaction occurred, i.e., for every dollar of tax revenue lost, $.60 to $.80 was received by the party that sold the tax benefits; the remainder went to other parties.

Uncertainty

Second, inefficiencies arise when it is not clear that the taxable entity will get the full benefit of the tax incentives, either because the facts of the transactions or the law applicable to the transaction is not clear. Such uncertainty has a major impact on the negotiation process in which tax benefits are sold. Tax benefits usually are only one of several elements of a transaction that often have significant amounts of uncertainty. The larger the number of uncertainties, the more likely that the negotiations will be handled on a subjective basis and that uncertainties will be traded off against each other. Such uncertainties and trade-offs make it extremely difficult to determine accurately the amount of the tax incentives and the beneficiary or beneficiaries, of the tax incentives. Therefore, it is more likely that use of tax incentives will be more inefficient.

Lack of clear facts can arise from uncertainty in past as well as future events. For example, in the case of a purchase of net operating losses (NOLs), a purchaser normally would discount the potential value of the NOLs for the possibility that the size of the NOLs may be reduced by subsequent audit adjustments by the IRS (i.e., prior facts are unclear at the time of the sale of the NOL). Similarly, the value of the NOL would be discounted by a purchaser for the probability that the purchaser would not have enough future taxable income to absorb fully the NOL (i.e., future facts are unclear). Inefficiency also can arise because the amount of the discount is determined by negotiation between the parties, each of which might have different knowledge of the relevant facts.

Uncertainty of the law can arise from a variety of sources. Provisions of law frequently contain ambiguities that affect the value of the tax benefits provided by a provision. These uncertainties affect the value of the tax incentive because each party may negotiate based upon different assumptions about what is actually the law. In addition, if there is litigation over the interpretation of an aspect of the law, there may be uncertainty due to nonuniformity of interpretation by the courts. Moreover, tax incentives that are not immediately available might be discounted to account for the possibility that there might be future changes in law that disallow or decrease the value of the tax incentive.[77]

Transaction costs

Third, inefficiencies can arise because of fees charged by lawyers, investment bankers, and other third party agents involved in putting together the transaction.

B. Fairness of the Tax System

A fundamental principle of U.S. tax policy has been that the tax system should be structured so as to be as fair as possible. Studies have shown that voluntary compliance with the tax law declines rapidly to the extent people believe the tax system to be inequita-

[77] For example, the 1986 Act both lowered the tax rates and placed limitations on deductions from passive activities.

ble.[78] This analysis suggests that Congress should closely examine any provision of the tax law that is deemed unfair.

There are at least two theories as to why taxpayers would believe that a particular provision is unfair. First, a provision may be considered unfair where the provisions are used by well-known, profitable corporations to such a large extent that the corporations are able to significantly reduce their Federal income tax, while other taxpayers generally cannot make use of such provisions.

Second, a fairness problem can arise any time tax avoidance is a significant motivation for a transaction. This is particularly true where the provision provides tax benefits that have little relationship to the economic substance of the transaction.

C. Operation of the Deposit Insurance Program

The availability of tax-favored provisions has an impact on the operations of the deposit insurance system in at least three respects. First, as indicated above, provisions can benefit the deposit insurer (the FSLIC or the FDIC) or a troubled financial institution only by providing tax benefits to transactions between those parties and a taxable entity (since the FSLIC and the FDIC are not subject to Federal income tax and troubled financial institutions are effectively exempt from tax because of net operating loss deductions). The tax incentives of present law for financially troubled financial institutions provide the greatest benefits where there is a tax-free merger of a financially troubled financial institution with a taxable acquiring entity. Because the greatest tax benefits associated with these incentives are available where a tax-free merger take place, these tax incentives tend to favor the merger of financially troubled financial institutions even where the better course of dealing with that institution might be liquidation or merely continuation of the existing institution under new management.

Second, because tax incentives provide a benefit only if they reduce the taxes of a taxable entity, the class of potential purchasers tends to be limited to large taxpayers with significant taxable income. Large taxpayers who purchase these institutions may not have as much experience in operating a financial institution as some smaller taxpayers who cannot otherwise use the tax benefits. Moreover, a high level of taxable income do not assure that the purchaser is financially strong.

Lastly, the FSLIC is authorized to provide assistance generally only to the extent that the assistance does not exceed the cost of liquidation.[79] It is not clear how fully the cost of the tax benefits has been considered in determining whether the total cost is less than that of liquidation. Even if the FSLIC does attempt to value the tax benefits for this purpose, it may be extremely difficult for the FSLIC to determine the amount of actual tax benefits involved due to uncertainty about facts relating to the acquirer's tax position.

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[78] *See, e.g.*, Spicer and Lundstedt, "Understanding Tax Evasion," 31 *Public Finance* 295 (1976); Spicer and Becker, "Fiscal Inequality and Tax Evasion: An Experimental Approach," 33 *National Tax Journal* 171 (1980).

[79] See text of footnote 12, *supra*.

D. Budget Process

A fourth issue is the impact of tax-favored transactions on the budget process. Tax-favored transactions shift program costs to the Treasury in the form of reduced tax revenues. Tax-favored transactions have the characteristic of making it is very difficult to determine how much Federal assistance is being provided and to whom the assistance is going. Moreover, tax incentives reduce the control over spending normally exercised by the budget process by converting direct outlays, which normally require appropriation, into tax benefits, which do not. Thus, expenditures from tax-favored transactions are often less subject to public scrutiny and control than direct expenditures.

The revenue effect from tax-favored transactions is reflected currently in the size of the current deficit or surplus. Thus, tax incentives cannot be used on an "off-budget" basis. Nonetheless, many tax incentives have the effect of spreading the cost of the benefit over a number of years and thereby making the budget effect of a provision appear to be small when revenue effects are measured by relatively short periods that are commonly used to measure the budgetary impact of tax provisions. See Part I.B.3. of this pamphlet, *supra,* for further discussion of the interaction of tax expenditures and direct outlays.

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